[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986

(H.R. 3838, 99TH CONGRESS; PUBLIC LAW 99-514)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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XVI

LETTER OF TRANSMITTAL

U.S. Congress,
Joint Committee on Taxation,
Washington, DC, May 4, 1987.

Hon. Dan Rostenkowski, *Chairman,*
Hon. Lloyd Bentsen, *Vice-Chairman,*
Joint Committee on Taxation,
U.S. Congress, Washington, DC.

Dear Messrs. Chairmen: This document, the General Explanation of the Tax Reform Act of 1986 (P.L. 99-514), was prepared by the staff of the Joint Committee on Taxation, in consultation with the staffs of the House Committee on Ways and Means and the Senate Committee on Finance. It is comparable to similar material prepared by the Joint Committee staff with respect to other major revenue acts in recent years.

A committee report on legislation issued by a Congressional committee sets forth the committee's explanation of the bill as it was reported by that committee. In some instances, a committee report does not also serve as an explanation of the final provisions of the legislation as enacted by the Congress. This is because the versions of the bill reported by the House and Senate committees may differ significantly from the versions of the bill as passed by the House, as passed by the Senate, or as enacted after action by a conference committee.

The Tax Reform Act of 1986, because of its comprehensive scope and the numerous changes which were made to the bill by the Senate and the conference committee, is an example of legislation with respect to which the differences between provisions of the reported bill or committee amendment and provisions of the public law are significant.

The first part of the document is an overall chronology of the legislative background of the Act in the 99th Congress. (In addition to this overall chronology, specific references to the legislative background of each provision of the Act are set forth in footnotes accompanying the explanations of the provisions in the third part of the document.) The second part presents the general reasons for the legislation. The third part consists of explanations of the provisions of the Act. (Title XVIII of the Act, making technical corrections to prior tax legislation, is not described in this document.) An appendix sets forth the estimated budget effects of the provisions of the Act described in the document for fiscal years 1987-1991.

Sincerely yours,

David H. Brockway, *Chief of Staff.*

I. LEGISLATIVE BACKGROUND OF THE ACT

The following is an overall chronology of the legislative background in the 99th Congress of H.R. 3838, the Tax Reform Act of 1986 (Public Law 99-514).[1]

A. Administration Tax Reform Proposal

In May 1985, President Reagan submitted the Administration's tax reform proposals to the Congress.[2] Previously, the Treasury Department, in response to the President's request in his 1984 State of the Union Address, had conducted a comprehensive study of the U.S. tax system and submitted the results of the study with recommendations to the President in November 1984.[3]

B. House Action

Ways and Means Committee

H.R. 3838 was introduced and ordered favorably reported by the House Committee on Ways and Means on December 3, 1985, after almost a year-long review of tax reform proposals by the full committee and subcommittees in public hearings and in markup consideration. The following is an overview of full committee and subcommittee activity on tax reform legislation during 1985.

Committee hearings

The Ways and Means Committee held 30 days of full committee public hearings on comprehensive tax reform proposals. The committee began public hearings on comprehensive tax reform proposals on February 27, 1985. Committee hearings on tax reform issues continued on March 26; May 30; June 4, 5, 7, 11-14, 17, 18, 20, 24-27; and July 8-12, 17, 19, 22, 25, 26, 29-31, 1985. Also, a committee hearing was held on May 16, 1985, on proposed technical corrections to the Deficit Reduction Act of 1984 (P.L. 98-369) and the Retirement Equity Act of 1984 (P.L. 98-397).

The committee's tax reform hearing consideration included 1984 Treasury Department recommendations, the President's tax reform proposal made in May 1985, as well as various Congressional and other proposals.

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[1] In addition to this overall chronology of the Act, specific references to the legislative background of each provision are set forth in footnotes accompanying the explanation of the provisions in Part III of this document. These legislative background references include, as appropriate, citations to the following: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985 (H. Rep. 99-426); H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986 (S. Rep. 99-313); House and Senate floor amendments to H.R. 3838; and the conference report on H.R. 3838 as filed on September 18, 1986 (H. Rep. 99-841).

[2] The White House, *The President's Tax Reform Proposals to the Congress for Fairness, Growth, and Simplicity*, May 1985.

[3] Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth*, November 1984.

Subcommittee hearings

Several Ways and Means Subcommittee hearings were held during 1985 that related to subject matters included in H.R. 3838.

Subcommittee on Select Revenue Measures.—The Select Revenue Measures Subcommittee held hearings on the following areas:

March 19, 1985 — Targeted jobs tax credit

April 1, 2, 16, 1985 — Acquisitions and mergers (with Oversight Subcommittee)

April 25, 1985 — Attorney's fees

May 22, 1985 — Carryover of net operating losses (NOLs)

June 6, 1985 — Tax burdens of low-income wage earners

Subcommittee on Oversight.—The Oversight Subcommittee held hearings on the following areas:

June 21, 1985 — IRS taxpayer refund delays

July 18, and September 5, 6, 1985 — Retirement income security (with Social Security Subcommittee)

September 20, 1985 — High-income taxpayers and partnership tax issues

Committee markup

The Ways and Means Committee conducted 26 days of markup on tax reform proposals: beginning on September 18, 1985; continuing on September 26, 30, October 1-4, 7-9, 11, 15, 23, 25-27, November 6, 15-17, 19-23; and concluding on December 3, 1985, when the tax reform bill, H.R. 3838, was introduced and ordered favorably reported (by a vote of 28-8). There was also a committee markup on technical corrections to the 1984 tax legislation on September 27, 1985, which was included as a separate title of the bill.

The committee report on H.R. 3838 was filed on December 7, 1985 (H. Rep. 99-426).

House Floor Action

On December 10, 1985, the House Rules Committee approved a modified closed rule on H.R. 3838 (H. Res. 336), making certain amendments in order for House floor consideration. This initial rule failed of passage (202-223, 1 "present") on December 11, 1985. On December 16, 1985, the Rules Committee approved another modified closed rule (H. Res. 343), which was adopted (258-168, 1 "present") by the House on December 17, 1985.

The House passed H.R. 3838, as amended, by voice vote, on December 17, 1985.

C. Senate Action

Finance Committee

H.R. 3838 was ordered favorably reported by the Senate Committee on Finance on May 6, 1986, with an amendment in the nature of a substitute. This action followed an almost year-long comprehensive review in the 99th Congress of tax reform proposals by the full committee and subcommittees in public hearings and markup consideration. The following is an overview of full committee and subcommittee activity on tax reform legislation during 1985 and 1986.

Committee hearings

The Finance Committee held 36 days of full committee public hearings on comprehensive tax reform proposals in 1985 and 1986. In 1985, the committee held public hearings on comprehensive tax reform proposals on May 9, June 11-13, 17-20, and 25-27; July 9-11, 16-19, and 24-25; September 24 and 26; and October 1-4 and 9-10. In 1986, committee hearings were held on January 29-30; February 3-16; March 4; and April 21.

The committee's tax reform hearing consideration included the President's tax reform proposal made in May 1985, the House-passed bill, and various Congressional and other proposals.

Subcommittee hearings

Several Finance Subcommittee hearings were held during 1985 and 1986 that related to subject matters included in H.R. 3838, as amended by the Committee on Finance.

Subcommittee on Savings, Pensions, and Investment Policy.—The Savings, Pensions, and Investment Policy Subcommittee held hearings on the following areas:

September 9, 1985 — Post-retirement health benefits

November 22, 1985 — Targeted jobs tax credit extension

January 28, 1986 — Retirement Income Policy Act

Subcommittee on Energy and Agricultural Taxation.—The Energy and Agricultural Taxation Subcommittee held a hearing on the following area:

June 21, 1985 — Impact of taxation on energy policy

Subcommittee on Health.—The Health Subcommittee held a hearing on the following area:

September 9, 1985 — Asbestos-related disease trust fund

Subcommittee on Taxation and Debt Management.—The Taxation and Debt Management Subcommittee held a hearing on the following area:

January 31, 1986 — Mortgage-backed securities

Committee markup and reporting of bill

The Finance Committee conducted 17 days of markup on the tax reform bill: beginning on March 19, 1986; continuing on March 24-26, April 8-10, 14-18, 22, 24, 28, and May 5; and concluding on May 6, 1986, when the tax reform bill, H.R. 3838, as amended, was ordered favorably reported (by a vote of 20-0).

The committee report on H.R. 3838 was filed on May 29, 1986 (S. Rep. 99-313).

Senate Floor Action

H.R. 3838, as amended by the Finance Committee, was brought up on the Senate floor on June 4, 1986, and debate on the bill continued on June 9-13, 16-20, and 23-24, 1986, with passage of the bill, as amended, on June 24 (by vote of 97-3).

D. Conference Action

Conference

The Senate requested a conference on H.R. 3838 on July 15, 1986, and appointed the following conferees: Senators Packwood, Dole, Roth, Danforth, Chafee, Wallop, Long, Bentsen, Matsunaga, Moynihan, and Bradley. On July 16, the House agreed to the Senate request for a conference on the bill, and appointed the following conferees: Messrs. Rostenkowski, Pickle, Rangel, Stark, Gephardt, Russo, Pease, Duncan, Archer, Vander Jagt, and Crane.

Formal conference committee meetings were held on July 17-18 and 21, 1986, and concluded on August 16, 1986, when the conferees met and approved the conference agreement. The conference report on H.R. 3838 was filed on September 18, 1986 (H. Rep. 99-841, Vols. I and II).

House-Senate consideration of Conference Report

The House approved the conference report on H.R. 3838 on September 25, 1986, by a vote of 292-136, after a motion to recommit failed by a vote of 160-268. The conference report was considered by the Senate on September 26, 1986, and passed by a vote of 74-23 on September 27, 1986.

E. Enactment into Law

H.R. 3838, the Tax Reform Act of 1986, was signed into law by President Reagan on October 22, 1986 (P.L. 99-514).

F. House-Senate Consideration of H. Con. Res. 395

On September 25, 1986, immediately after its approval of the conference report on H.R. 3838, the House passed (by voice vote) H. Con. Res. 395, to instruct the enrolling clerk to make certain technical and clerical corrections in the conference report statute.

H. Con. Res. 395 was agreed to by the Senate (by voice vote) on October 16, 1986, with amendments. The House Rules Committee granted a rule on October 16, and the House adopted the rule (by voice vote) on October 17 for consideration of the resolution as amended by the Senate. Also on October 17, the House concurred in the Senate amendment with further amendments and returned the resolution to the Senate.

On October 18, 1986, the Senate agreed (by voice vote) to certain of the House amendments to the resolution, disagreed to certain other amendments, and insisted on certain of its amendments. Also on October 18, the House disagreed to the Senate amendments to the House amendments to the original Senate amendment. H. Con. Res. 395 was not agreed to by both the House and the Senate before the 99th Congress adjourned *sine die* on October 18, 1986.

G. Subsequent Related Tax Legislation

H.R. 5300, the Omnibus Budget Reconciliation Act of 1986 (P. L. 99-509, signed on October 21, 1986), contains a provision (sec. 8002) increasing the Code section 6661(a) penalty on underpayments of tax to 25 percent rather than 20 percent as provided in H.R. 3838 (sec. 1504). The conference report on H.R. 5300 was filed on October 17, 1986 (H. Rep. 99-1012), and was passed by the Senate and the House also on October 17. Although H.R. 5300 was signed before H.R. 3838, the H.R. 5300 provision was intended to prevail since it was considered and passed by the House and the Senate subsequent to passage of H.R. 3838.[4]

In addition, H.R. 5300 includes a provision (sec. 8071) relating to a truck leasing transitional rule included in the Senate amendment to H.R. 3838 (sec. 204(a)), application of at-risk rule to low-income housing credit (sec. 8072 of H.R. 5300 and sec. 252(a) of H.R. 3838), and a transitional rule relating to treatment of certain rural housing under the passive loss rules (sec. 8073 of H.R. 5300 and sec. 502(d) of H.R. 3838).

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[4] See explanation in Title XV. Part. A., footnote 14. A technical correction may be needed so that the statute reflects this intent.

II. GENERAL REASONS FOR THE ACT

Overview

The Tax Reform Act of 1986 (the "Act") represents one of the most comprehensive revisions of the Federal income tax system since its inception. Congress was concerned that many taxpayers found the prior-law tax system unfair and overly complex. Further, Congress believed that a number of features of the prior-law tax system resulted in excessive interference in labor, investment, and consumption decisions of taxpayers.

After extensive review of virtually the entire prior tax statute, Congress concluded that only a thorough reform could assure a fairer, more efficient, and simpler tax system. Congress believed that the Act, establishing the Internal Revenue Code of 1986, will restore the trust of the American people in the income tax system and lead the nation's economy into greater productivity.

The Act makes sweeping changes to the prior-law tax system. First, Congress desired a fairer tax system. Congress questioned the fairness of a tax system that allowed some high-income individuals to pay far lower rates of tax than other, less affluent individuals. The Act provides new limitations on the use of losses from passive investments to shelter other types of income and expands the minimum tax to curtail these tax inequities in the future. The Act also completely removes six million low-income individuals from the income tax roll and provides significant reductions in the tax burden of other working low-income individuals.

Second, Congress desired a more efficient tax system. The prior-law tax system intruded at nearly every level of decision-making by businesses and consumers. The sharp reductions in individual and corporate tax rates provided by the Act and the elimination of many tax preferences will directly remove or lessen tax considerations in labor, investment and consumption decisions. The Act enables businesses to compete on a more equal basis, and business success will be determined more by serving the changing needs of a dynamic economy and less by relying on subsidies provided by the tax code.

Third, Congress desired a simpler tax system for individuals. Beginning in 1988, the Act establishes two individual income tax rates—15 percent and 28 percent—to replace more than a dozen tax rates in each of the prior-law rate schedules, which extended up to 50 percent. Significant increases in the standard deduction and modifications to certain personal deductions provide further simplicity by greatly reducing the number of taxpayers who will itemize their deductions.

Fairness

A primary objective of Congress was to provide a tax system that ensures that individuals with similar incomes pay similar amounts of tax. The ability of some individuals to reduce their tax liability excessively under prior law eroded the tax base and required tax rates to be higher than otherwise would have been necessary. Congress was concerned that other individuals, unable to take advantage of tax shelters, had lost confidence in the tax system and may have responded by evading their tax liability.

The Act provides a new restriction on the use of passive losses to offset unrelated income. Further, a strengthened minimum tax precludes higher income individuals from substantially eliminating income tax liability through the excessive use of preferences. With the adoption of these restrictions, the elimination of other preferences, and other base-broadening provisions, the Act sharply reduces the top individual tax rate from 50 percent to 28 percent, while leaving the tax burden of the highest income groups essentially unchanged.

Congress believed that as a result of the sharp reductions in tax rates, it was no longer necessary to provide a lower tax rate for capital gains income of individuals. Eliminating the preferential treatment of capital gains income, and thereby eliminating the incentive to recharacterize certain income in order to qualify for capital gains treatment, is expected to eliminate the abuse of this provision and reduce the complexity of the tax system.

The Act retains the most widely utilized itemized deductions, including deductions for home mortgage interest, State and local income taxes, real estate and personal property taxes, charitable contributions, casualty and theft losses, and medical expenses (above an increased floor). Other deductions that benefited a limited number of taxpayers, added complexity to tax filing, or were subject to abuse are restricted by the Act. For example, the Act tightens the requirements for deducting business meals and permits only 80 percent of business meal and entertainment expenses to be deducted. Other deductions available under prior law, such as deductions for attending investment seminars and for "educational" travel costs, have been eliminated. These expenditures differ little from other personal consumption expenditures, which generally are not deductible.

As part of the approach of the Act to reduce tax rates through base-broadening, the Act disallows the itemized deductions for State and local sales taxes and phases out the deduction for personal interest expense for other than a mortgage on a first or second home. Congress also believed that these deductions provided tax benefits for consumption at the expense of savings and resulted in unnecessary complexity.

Certain items of income that are similar to taxable compensation are no longer excluded from taxable income under the Act. For example, the prior-law partial exclusion for unemployment compensation is repealed, and most prizes and awards are includable in income. Also, the Act restricts the prior-law practice of some high-income families taking advantage of the graduated rate structure by transferring investment property to their minor children and thus sheltering their investment earnings at their children's lower tax rates.

The Act makes numerous changes to increase employee eligibility for pension benefits. The Act expands the rules requiring coverage of a broad group of employees under an employer-maintained retirement plan, reduces from 10 years to five years the maximum time an employee must work for a given employer before becoming vested, and eliminates the ability of employers to offset completely the pension benefits of low-paid workers by the amount of their social security benefits. The Act also reduces the amount of income that can be deferred from taxation using qualified cash or deferred arrangements (sec. 401(k) and 403(b) plans), and provides tighter nondiscrimination tests to ensure that such plans do not disproportionately benefit highly compensated employees.

Congress believed the prior-law tax treatment of individual retirement accounts (IRAs) was unnecessarily generous for individuals who participate in other tax-favored retirement arrangements, and the Act eliminates the deduction for contributions to an IRA for such individuals with income above specified levels. Congress believed that the lower tax rates provided by the Act will themselves stimulate additional work effort and saving, thereby eliminating the need for this deduction for these individuals. The Act permits these individuals, however, to make nondeductible contributions to an IRA and to defer taxes on the earnings of these contributions. To ensure universal availability of tax-favored retirement arrangements, the Act retains the prior-law IRA deduction for individuals unable to participate in other plans.

In addition to ensuring that high-income taxpayers pay their share of the Federal tax burden, the Act provides tax relief to low- and middle-income wage earners. To achieve this goal, the Act substantially increases the standard deduction (the prior-law zero bracket amount) and almost doubles the personal exemption. Together with the greatly expanded earned income credit, these provisions relieve approximately six million low-income individuals from income tax liability and ensure that no families below the poverty level will have Federal income tax liability. The child care credit is preserved to assist working parents with their dependent care expenses.

The elderly and blind also receive tax relief under the Act. Although such individuals will not receive an extra personal exemption as under prior law, an additional standard deduction amount of $600 is provided for married elderly or blind individuals and of $750 for single elderly or blind individuals. These extra standard deduction amounts are in addition to the increased standard deduction and personal exemption provided for all taxpayers. The prior-law credit for certain elderly individuals and for individuals who are permanently and totally disabled is retained.

Congress also believed that fairness in the tax system requires that corporate taxpayers pay amounts of tax appropriate for their level of earnings. Congress found it unjustifiable that under prior law some corporations reported large earnings and paid significant dividends to their shareholders, yet paid little or no taxes on that income to the government. Congress designed a strong alternative minimum tax for corporations, with a broad income tax base, to prevent corporations from significantly reducing or eliminating their tax liability.

The Act makes changes to several accounting rules to provide more accurate matching between the recognition of income and deductions for expenditures related to this income. Large commercial banks will no longer be allowed to take deductions for bad debts before the underlying loan is determined to be wholly or partially worthless. Use of the installment method is restricted, and certain costs of inventory and self-constructed assets are required to be capitalized under the Act. Use of the completed contract method also is limited. Similarly, the Act reduces the deduction for unpaid losses of property and casualty insurance companies to account better for the timing difference beween the deduction and payment of losses.

The Act modifies the tax treatment of foreign income. Congress desired to limit the incentives under prior law to move income offshore to avoid tax; accordingly, the Act restricts the ability of firms to use tax havens. The Act also limits the ability of taxpayers to use foreign taxes imposed on one kind of income to offset U.S. tax on unrelated income. The Act further provides for more accurate characterization of income as foreign source (and thus eligible for the foreign tax credit) or U.S. source (and thus ineligible for that credit). Certain provisions of prior law that benefited U.S. exporters paying high foreign taxes were retained, however, so as not to hinder the international competitiveness of U.S. firms.

Together with other changes made by the Act, the aggregate corporate income tax liability is estimated to increase by approximately $120 billion over fiscal years 1987 through 1991, while the aggregate individual income tax liability is reduced by a similar amount. Even with these changes, the share of total income tax receipts paid by corporations will remain below pre-1980 levels.

Congress also believed that it is important to maintain the trust of honest taxpayers in the tax system by ensuring that other taxpayers cannot illegally evade their tax liability. The Act extends information reporting requirements and provides for increased penalties for failure to report information properly to the Internal Revenue Service and for failure to pay tax.

Efficiency

The Act's most important measures in promoting the efficiency of the economy and in reducing the interference of the tax system in labor, investment, and consumption decisions are the dramatic reductions in personal and corporate tax rates. Lower marginal tax rates stimulate work effort and saving by leaving more of each additional dollar of wage and investment income in the hands of the taxpayer. Further, lower tax rates reduce the value of tax deductions, leading investment and consumption decisions to be made more on the basis of their economic merits and less on the value of tax benefits.

The prior-law tax system contained a number of tax preferences that did not satisfactorily serve the purposes for which they were designed. In the past few years, tax incentives have contributed to the excessive construction of office buildings and record vacancy rates, excess investment in agriculture tax shelters by high-income investors with little knowledge of farming, and distortions at all levels of business—from financing choices to production decisions.

Congress desired to make the tax treatment of diverse economic activities more even. Neutral taxation promotes the efficient allocation of investment and yields productivity gains without requiring additional saving. The Act repeals the investment tax credit, which discriminated against long-lived investment and was used as a tax shelter device. The incentive for investment provided by the credit instead will be provided by lower tax rates and accelerated depreciation.

The Act retains the prior-law Accelerated Cost Recovery System with some modifications to provide for more neutral depreciation treatment across diverse assets. The depreciation period of certain assets, such as real property and long-lived equipment, is lengthened to reflect more closely the actual useful life of such assets. Congress believed these changes will help provide a more efficient capital cost recovery system.

Tax incentives under prior law favoring mergers and acquisitions also are restricted by the Act. The Act repeals the *General Utilities* doctrine, which allowed capital gains from corporate liquidations to escape tax at the corporate level. The *General Utilities* doctrine created a bias favoring acquisitions as a technique for tax-free realization of corporate gains and at the same time allowing the purchaser of the liquidating corporation's assets a higher basis for purposes of depreciation and depletion. The Act further reduces the incentive for tax-motivated corporate acquisitions by limiting the use of net operating losses obtained through an acquisition to offset income of the acquiring firm.

The Act also adopts reforms affecting the availability of tax-exempt financing. The Act restricts tax-exempt financing for fundamentally private activities and discourages the issuance of tax-exempt bonds which under prior law was motivated in part by the opportunity to gain arbitrage profits.

The Act generally preserves the prior-law treatment of natural resources and retains a number of business incentives that Congress believed to be beneficial to the economy. The incremental research tax credit, which was scheduled to expire at the end of 1985, was extended for three additional years at a 20-percent rate. The benefits of research expenditures to the economy as a whole are frequently greater than the rewards received by those undertaking the risks of research; extending the credit helps ensure that adequate amounts of research are undertaken to enhance productivity. Certain expired business energy tax credits also are temporarily extended by the Act, although at reduced rates.

The Act provides a new tax credit for low-income rental housing to consolidate the uncoordinated subsidies under prior law. The credit is better targeted to low-income individuals than prior-law provisions, and requires that tenants' rents be limited to affordable amounts in relation to their incomes. The Act also preserves rehabilitation tax credits for historic and pre-1936 structures at a reduced rate. The credit has been found to be useful in revitalizing depressed urban areas and in preserving America's architectural past for future generations.

Simplicity

Under prior law, many taxpayers were concerned with the recordkeeping, paperwork, and computations necessitated by tax filing. Many taxpayers felt a need to rely on paid tax preparers in order to calculate accurately their tax liability. The complexity of the tax code was further increased by other taxpayers who, seeking to reduce their tax liability, helped spawn a thriving tax shelter industry which sought to reduce tax liability by making use of special tax provisions and by engaging in sophisticated financial arrangements. The cost to taxpayers of complying with all the requirements of the individual income tax under prior law in terms of the time spent on recordkeeping and tax filing was estimated to equal 5 to 10 percent of the tax actually paid. Thus, simplification of the tax code itself is a form of tax reduction.

The Act reduces the complexity of the tax code for many Americans. The Act provides just two individual tax brackets, and over 80 percent of all individual taxpayers will pay no tax or tax at a marginal rate no higher than 15 percent. As a result of the significant increases in the standard deduction and modifications to certain personal deductions provided by the Act, the number of itemizers is estimated to decline by approximately one-quarter. Taxpayers who will use the standard deduction rather than itemize their deductions will be freed from much of the recordkeeping, paperwork, and computations that were required under prior law.

Other individuals who under prior law devoted a great amount of time and effort to find investments that reduced their tax liability also benefit from tax simplification. Many of these investments would have been unprofitable if not for the paper losses they created. With the significant rate reductions achieved by this Act, many taxpayers will find such investments unnecessary and noncompetitive with other less complex and more productive investments.

Some taxpayers who under prior law used various preferences to reduce their tax liability by large amounts may find that the Act does not simplify the tax filing process for them as much as it does for other individuals. In part, the complexity of the tax system for these individuals is needed to measure accurately their income and to ensure that these individuals pay a rate of tax appropriate for their income.

In conclusion, Congress believed that the Tax Reform Act of 1986 provides a fairer, more efficient, and simpler tax system. The changes made by this Act represent a historic reform of the Federal income tax structure. By providing sharply lower tax rates to individuals and corporations, the need for special tax preferences is greatly diminished. The Act eliminates needless interference with economic activity and establishes the framework for a growing and productive economy.

III. GENERAL EXPLANATION OF THE ACT

TITLE I—INDIVIDUAL INCOME TAX PROVISIONS

A. Basic Rate Structure:

Rate Reductions; Increase in Standard Deduction and Personal Exemptions; Repeal of Two-Earner Deduction and Income Averaging (Secs. 101-104, 131, 141, and 151 of the Act and secs. 1, 63, 151, and 221 of the Code) [1]

Prior Law

Tax rate schedules

Filing status classifications

Separate tax rate schedules are provided for the four filing status classifications applicable to individuals—(1) married individuals filing jointly [2] and certain surviving spouses; (2) heads of household; (3) single individuals; and (4) married individuals filing separately.

In general, the term head of household means an unmarried individual (other than a surviving spouse) who pays more than one-half the expenses of maintaining a home for himself or herself and for a child or dependent relative who lives with the taxpayer, or who pays more than one-half the expenses, and of the cost of maintaining their household, of his or her dependent parents. An unmarried surviving spouse may use the rate schedule for married individuals filing jointly in computing tax liability for the two years following the year in which his or her spouse died if the surviving spouse maintains a household that includes a dependent child.

Computation of tax liability

Federal income tax liability is calculated by applying the tax rates from the appropriate schedule to the individual's taxable income, and then subtracting any allowable tax credits. Under prior law, taxable income equalled adjusted gross income (gross income less certain exclusions and deductions) minus personal exemptions, and minus itemized deductions to the extent they exceeded the zero bracket amount (ZBA). For 1986, individuals who did not itemize were allowed a deduction for charitable contributions in addition to the ZBA.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 101-03, 131; H.Rep. 99-426, pp. 80-93; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 101-04, 131, and 151; S.Rep. 99-313, pp. 29-42; Senate floor amendment, 132 Cong. Rec. S 7665-73 (June 17, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 1-11 (Conference Report).

[2] For tax purposes, an individual's marital status for a year generally is determined on the last day of the year. If one spouse dies during the year, the surviving spouse generally is eligible to file a joint return for that year.

The prior-law rate schedules included the zero (tax rate) bracket amount as the first bracket; the ZBA was provided in lieu of a standard deduction. The prior-law rate structure consisted of up to 15 taxable income brackets and tax rates beginning above the ZBA.

1986 tax-rate schedules

The following rate schedule provisions applied for 1986 and reflected an adjustment for 1985 inflation.

Married individuals; surviving spouses.—There were 14 taxable income brackets above the ZBA of $3,670. The minimum 11-percent rate started at taxable income above $3,670; the maximum 50-percent rate started at taxable income above $175,250.

For married individuals filing separate returns, the ZBA was one-half the ZBA on joint returns, and the taxable income bracket amounts began at one-half the amounts for joint returns.

Heads of household.—There were 14 taxable income brackets above the $2,480 ZBA. The minimum 11-percent tax rate started at taxable income above $2,480; the maximum 50-percent rate started at taxable income above $116,870. The tax rates applicable to a head of household were lower than those applicable to other unmarried individuals on taxable income above $13,920. Thus, a head of household in effect received a portion of the benefits of the lower rates accorded to a married couple filing a joint return.

Single individuals.—There were 15 taxable income brackets above the $2,480 ZBA for single individuals (other than heads of household or surviving spouses). The minimum 11-percent tax rate started at taxable income above $2,480; the maximum 50-percent rate started at taxable income above $88,270.

The bracket dollar amounts described above for 1986 were indexed to reflect an inflation rate of approximately four percent in the preceding fiscal year, i.e., for the 12-month period ending September 30, 1985. For 1987 and later years, prior law would have provided that the dollar figures defining the tax brackets were to be adjusted annually according to annual percentage changes in the consumer price index for the 12-month period ending September 30 of the preceding year.

Standard deduction (zero bracket amount)

Under prior law, the first positive taxable income bracket (i.e., the 11-percent marginal tax rate bracket) began just above the ZBA. The following ZBA amounts applied for 1986 and reflected an adjustment for 1985 inflation.

Filing status	*ZBA*
Joint returns and surviving spouses	$3,670
Heads of household	2,480
Single individuals	2,480
Married individuals filing separately	1,835

The ZBA also served under prior law as a floor under the amount of itemized deductions. Itemizers reduced their AGI by their personal exemptions and by the excess of their itemized deductions over the appropriate ZBA, in order to avoid doubling the benefit of the ZBA, and then used the appropriate tax rate schedule or tax table to compute or find their tax liability.

Personal exemption

Exemption amount.—For 1986, the personal exemption amount for an individual, the individual's spouse, and each dependent was $1,080. Under prior law, one additional personal exemption was provided for an individual who was age 65 or older, and for an individual taxpayer who was blind.

Rules for dependents.—Under prior law, a taxpayer could claim a personal exemption for himself or herself and for each additional dependent—spouse, child, or other individual—whose gross income did not exceed the personal exemption amount. In addition, parents could claim a personal exemption for a dependent child (for whom they provided more than one-half the support) who had income exceeding the personal exemption amount if the dependent child was either under age 19 or a full-time student. The child or other dependent also could claim a full personal exemption on his or her return.

A child eligible to be claimed as a dependent on his or her parents' return could use the ZBA only to offset earned income. Thus, a child with unearned income exceeding the personal exemption amount was required to file a return and pay tax on the excess (reduced by any allowable itemized deductions).

Adjustments for inflation

Under prior law, the dollar amounts defining the tax rate brackets, the ZBA (standard deduction), and the personal exemption amount were adjusted annually for inflation, measured by changes in the Consumer Price Index for all urban consumers (CPI) over the 12-month period ending September 30 of the prior calendar year. If the inflation adjustment was not a multiple of $10, the increase was rounded (up or down) to the nearest multiple of $10.

Two-earner deduction

Under prior law, married individuals filing a joint return were allowed a deduction equal to 10 percent of the lesser of the earned income of the lower-earning spouse or $30,000; the maximum deduction thus was $3,000.

Income averaging

An eligible individual could elect under prior law to have a lower marginal rate apply to the portion of the current year's taxable income that exceeded 140 percent of the average of his or her taxable income for the prior three years.

Reasons for Change

General objectives

The approach of the Act in broadening the base of the individual income tax allows a considerable reduction in marginal tax rates and in the overall income tax burden on individuals.

The provisions in the Act reducing tax rates for individuals, as well as increasing the standard deduction, the personal exemption, and the earned income credit, were fashioned to achieve three important objectives: (1) to eliminate income tax burdens for families with incomes below the poverty line; (2) to provide an equitable distribution of tax reductions among individuals; and (3) to reduce the marriage penalty sufficiently so that there is no need for an additional deduction for two-earner couples. In addition, the increase in the standard deduction, coupled with changes to the itemized deductions, will reduce the number of individuals who must itemize their deductions, and thus will contribute to a simpler tax system.

Relief for low-income families

A fundamental goal of the Congress was to relieve families with the lowest incomes from Federal income tax liability. Consequently, the Act increases the amounts of both the personal exemption and the standard deduction, as well as the earned income credit, so that the income level at which individuals begin to have tax liability (the tax threshold) will be raised sufficiently to remove six million poverty-level taxpayers from Federal income tax liability. This restores to the tax system an essential element of fairness that has been eroded since the last increase in the personal exemption.

The ZBA and personal exemption had been unchanged from the levels set in the Revenue Act of 1978, until inflation adjustments began in 1985. Notwithstanding these adjustments, inflation had reduced the real value of the standard deduction and personal exemption in setting a threshold level below which income was not taxed. Although the rate reductions in 1981 reduced tax liabilities partly in recognition of the burdens of inflation and social security taxes, those reductions did not provide relief for marginally taxable individuals who would not have been subject to tax liability but for past inflation.

The increase in the personal exemption to $1,900 in 1987 ($1,950 and $2,000 in 1988 and 1989) under the Act—the first statutory increase in the exemption since 1978—contributes both to removing the working poor from the tax rolls and extending relief to other low-income individuals. The personal exemption increase also recognizes the significant costs of raising children. The increases in the standard deduction and personal exemption reduce tax burdens for families (below the phase-out ranges) by raising the tax threshold.

Under the Act, all tax thresholds (the beginning point of income tax liability) are higher than the estimated poverty level for 1988 except for single individuals. In Table I-1 below, the columns showing calculations without taking into account the earned income credit reflect the fact that the tax threshold for heads of household (unmarried individuals who support children or certain dependent relatives) is raised proportionately more than the tax thresholds for married individuals filing jointly or single individuals. Married individuals receive a larger proportionate increase in the threshold than single individuals, in order to offset the effect of the repeal of the two-earner deduction. With the addition of the earned income credit to the computation, the tax threshold for those eligible for the credit rises even further.

Table I-1.—Income Tax Thresholds in 1988 Under Prior Law and Under the 1986 Act

Filing status	Family size	Including earned income credit		Without earned income credit		Estimated poverty level
		Prior law	1986 Act	Prior law	1986 Act	
Single	1	3,760	4,950	3,760	4,950	6,024
Joint	2	6,150	8,900	6,150	8,900	7,709
Head of household	2	8,110	12,416	4,900	8,300	7,709
Joint	4	9,783	15,116	8,430	12,800	12,104
Head of household	4	9,190	14,756	7,180	12,200	12,104

NOTE.—These calculations are based on the following assumptions: (1) inflation is equal to the figures forecast by the Congressional Budget Office in January 1987; (2) families with dependents are eligible for the earned income credit; (3) all income consists of money wages and salaries; and (4) taxpayers are under age 65.

There are two principal reasons why the tax threshold for single persons (other than heads of household) is not above the poverty line. First, any further increases in the standard deduction for single taxpayers beyond those provided by the Act would cause significant marriage penalties for two single individuals who married. Second, because the income of family members (other than spouses) is not combined in computing tax liability, and because the tax rate structure does not recognize economies of sharing household costs with other individuals, the income of single individuals does not represent a good measure of whether or not the living conditions of these individuals are impoverished.

More than two-thirds of all single individuals with income less than $10,000 are under age 25, according to 1984 census data; these individuals are likely to be receiving significant support from other family members that is not reflected on the tax return. In addition, the census data reflects that the majority of single individuals between ages 25 and 64 live with other individuals; thus, their household costs are shared. Accordingly, within the existing framework of defining the unit of tax liability, the Congress believed that the poverty line is not an accurate guide to the true economic circumstances of the majority of those who file tax returns as single individuals.

Equitable distribution of tax burden

The Congress also believed that it was desirable for the tax reductions provided under the Act to be distributed equitably among taxpayers. Table I-2 below shows the changes made by the Act in the distribution of the tax burden in 1987 and 1988; this table reflects the effect of major provisions affecting individuals, including the rate reductions, increases in the standard deduction and personal exemption, and changes in itemized deductions.

Table I-2 shows the percentage changes in tax liabilities between prior law and the Act for each of nine income classes. In the aggregate, the Act reduces tax liability of individuals by 2.2 percent in 1987 and by 6.1 percent in 1988.

Table I-2.—Percentage Change in 1987 and 1988 in Income Tax Liability Under the Tax Reform Act of 1986

Income class [thousands of 1986 dollars]	Percentage Change in Income Tax Liability	
	1987	1988
Less than $10	−57.2	−65.1
$10 to $20	−16.7	−22.3
$20 to $30	−10.8	−9.8
$30 to $40	−9.4	−7.7
$40 to $50	−9.8	−9.1
$50 to $75	−1.0	−1.8
$75 to $100	4.3	−1.2
$100 to $200	4.6	−2.2
$200 and above	9.8	−2.4
Total	−2.2	−6.1

NOTE.—These figures do not take account of certain provisions affecting individuals. Thus, the total tax reductions are somewhat different from what is indicated in this table.

Table I-3 shows average income tax liability and tax rate by income class for 1988, the first year in which the changes in the tax rates and standard deduction are fully effective. By virtue of restructuring the tax schedules and broadening the tax base for individuals, and reducing corporate tax preferences, the Act produces substantial reductions in individual income tax liabilities.

Table I-3.—Average Income Tax Liability and Tax Rates in 1988 Under Prior Law and Under the Tax Reform Act of 1986

Income class [thousands of 1986 dollars]	Average income tax			Average income tax rate (percent)	
	Prior law	1986 Act	Difference	Prior law	1986 Act
Less than $10	$60	$21	−$39	1.6	0.5
$10 to $20	895	695	−200	5.7	4.4
$20 to $30	2,238	2,018	−220	8.3	7.5
$30 to $40	3,527	3,254	−273	9.5	8.7
$40 to $50	5,335	4,849	−486	11.1	10.1
$50 to $75	8,538	8,388	−150	13.3	13.1
$75 to $100	14,469	14,293	−176	15.7	15.6
$100 to $200	27,965	27,353	−612	19.3	18.9
$200 and above	138,463	135,101	−3,362	22.8	22.3
Average tax liability or tax rate	3,176	2,982	−194	11.8	11.1

Note.—These figures do not take account of certain provisions affecting individuals. Thus, the total tax reductions are somewhat different from what is indicated in this table.

The income tax liability of individual taxpayers will decline an average of $194 in 1988, from an average $3,176 under prior law to an average $2,982 under the Act, as shown in Table I-3.

Simplification of tax returns

The Congress believed that the tax rate schedules in prior law were too lengthy and complicated. The Act provides a two-rate tax structure (15 and 28 percent), beginning in 1988. Under the Act, more than 80 percent of individuals either will be in the 15-percent bracket or will have no Federal income tax liability.

The prior-law tax rate structure is modified by the Act to make the individual income tax fairer and simpler and to reduce disincentives to economic efficiency and growth. Simplicity in the rate structure is achieved by using only two taxable income brackets. The four filing statuses are retained because they are the fewest classifications that can be implemented to provide fairly and equitably for the diverse characteristics of the taxpaying population.

The two-bracket tax structure replaces the prior-law ZBA with a standard deduction. Under the new structure, individuals determine taxable income by subtracting from adjusted gross income either the standard deduction or the total amount of allowable itemized deductions. Unlike the ZBA, the standard deduction enables the taxpayer to know directly how much income is subject to tax and to understand more clearly that taxable income is the base for determining tax liability.

Further, the difference between the standard deduction for an unmarried head of household and that for a married couple is narrowed by the Act in recognition that the costs of maintaining a household for an unmarried individual and a dependent more closely resemble the situation of a married couple than that of a single individual without a dependent.

The increases in the standard deduction and modifications to specific deduction provisions simplify the tax system by substantially reducing the number of itemizers. As a result of these changes, about 11 million itemizers will shift to using the standard deduction, a reduction of approximately 30 percent in the number of itemizers relative to prior law.

Marriage penalty

Under the Act, the adjustments of the standard deduction and the rate schedule make it possible to minimize the marriage penalty while repealing the two-earner deduction. As a result, single individuals who marry will retain more of the share of the standard deductions for two single individuals than under prior law.

Table I-4 presents a comparison of the marriage penalty in 1988 as it would be under prior law and as changed under the 1986 Act.

Table I-4.—Marriage Tax Penalty in 1988 for Two-Earner Couple Under Prior Law and Tax Reform Act of 1986

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$10,000					
Prior law	$88	$63	−$15	−$404	−$2,337
1986 Act	150	150	−443	−443	−1,548
$20,000					
Prior law	63	131	403	613	−885
1986 Act	150	158	466	466	−210
$30,000					
Prior law	−15	403	733	1,310	325
1986 Act	−443	466	774	774	529
$50,000					
Prior law	−404	613	1,310	2,609	2,243
1986 Act	−443	466	774	1,284	1,389
$100,000					
Prior law	−2,337	−885	325	2,243	3,974
1986 Act	−1,548	−210	529	1,389	1,494

NOTE.—The marriage bonus or penalty is the difference between the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person. Marriage bonuses are negative in the table; marriage penalties are positive. It is assumed that all income is earned, that taxpayers have no dependents, that deductible expenses were 16.7 percent of income under prior law and 14 percent of income under the Act, and that deductible expenses are allocated between spouses in proportion to income. The computations in the table reflect the standard deduction, personal exemption, rate bracket, and prior-law deduction for two-earner married couples.

Elderly and blind taxpayers

The tax burden on elderly or blind taxpayers is eased by the Act apart from the effect of rate reductions. The prior-law income tax credit for certain elderly or disabled individuals is retained.

As discussed above, the Act increases the standard deduction amounts and personal exemptions for all taxpayers. Thus, in 1989, the $2,000 personal exemption amount for each individual under the Act will be almost equal to the two personal exemption amounts allowed under prior law ($2,160 for 1986) for an elderly or blind individual. Also, the higher standard deduction amounts under the Act go into effect one year earlier (in 1987) for elderly or blind individuals than for all other taxpayers (in 1988). These increased amounts are further augmented under the Act by an additional standard deduction amount of $600 for an elderly or blind individual ($1,200, if both) who is married (or who is a surviving spouse), or of $750 for an unmarried elderly or blind individual ($1,500, if both). The higher personal exemptions and standard deduction, plus the additional standard deduction amount, offset the loss of the additional personal exemption under prior law.

Explanation of Provisions

1. Tax rate schedules

The rate structure under the Act consists of two brackets and tax rates—15 and 28 percent—for individuals in each of the four filing status classifications. Reflecting the replacement of the ZBA by the standard deduction, the 15-percent bracket begins at taxable income of zero. (Under the Act, taxable income equals AGI minus personal exemptions and minus either the standard deduction or the total of allowable itemized deductions.) Effective for taxable years beginning on or after January 1, 1988, the rate structure is as follows.

Tax rate	Taxable Income Brackets		
	Married, filing joint returns	Head of household	Single individual
15%	0 to $29,750	0 to $23,900	0 to $17,850
28%	Above $29,750	Above $23,900	Above $17,850

For married individuals filing separate returns, the 28-percent bracket begins at $14,875, i.e., one-half the taxable income amount for joint returns. The bracket amounts for surviving spouses are the same as those for married individuals filing joint returns.

Beginning in 1989, the taxable income amounts at which the 28-percent rate starts will be adjusted for inflation (as described below). By December 15 of each year, beginning in 1988, the Treasury Department is to prescribe tables reflecting the bracket amounts applicable for the following year as adjusted for inflation.

Rate adjustment

Beginning in 1988, the benefit of the 15-percent bracket is phased out for taxpayers having taxable income exceeding specified levels. The income tax liability of such taxpayers is increased by five percent of their taxable income within specified ranges, until the tax benefit of the 15-percent tax rate has been recaptured.

The rate adjustment occurs between $71,900 and $149,250 of taxable income for married individuals filing jointly and surviving spouses; between $61,650 and $123,790 of taxable income for heads of household; between $43,150 and $89,560 of taxable income for single individuals; and between $35,950 and $113,300 of taxable income for married individuals filing separately. These dollar amounts will be adjusted for inflation beginning in 1989.

The maximum amount of the rate adjustment generally equals 13 percent of the maximum amount of taxable income within the 15-percent bracket applicable to the taxpayer (for a married individual filing separately, in order to preclude an incentive for separate filing, it is the 15-percent bracket applicable for married taxpayers filing jointly). Thus, if the maximum rate adjustment applies, the 28-percent rate in effect applies to all of the taxpayer's taxable income, rather than only to the amount of taxable income above the bracket breakpoint.

Transitional rate structure for 1987

For taxable years beginning in 1987, rate schedules with five brackets are provided, as shown in the table below. Neither the rate adjustment (described above) nor the personal exemption phaseout (described below) applies to taxable years beginning in 1987.

Tax rate	Taxable Income Brackets		
	Married, filing joint returns	Head of household	Single individual
11%	0-$3,000	0-$2,500	0-$1,800
15%	3,000-28,000	2,500-23,000	1,800-16,800
28%	28,000-45,000	23,000-38,000	16,800-27,000
35%	45,000-90,000	38,000-80,000	27,000-54,000
38.5%	Over 90,000	Over 80,000	Over 54,000

For married individuals filing separate returns, the taxable income bracket amounts for 1987 begin at one-half the amounts for joint returns. The bracket amounts for surviving spouses are the same as those for married individuals filing joint returns.

2. Standard deduction

Increased deduction.—The Act repeals the zero bracket amount (ZBA) and substitutes a standard deduction of the following amounts, effective beginning in 1988.

Filing status	*Standard deduction*
Married individuals filing jointly; surviving spouses	$5,000
Heads of household	4,400
Single individuals	3,000
Married individuals filing separately	2,500

Beginning in 1989, these increased standard deduction amounts (designated the "basic standard deduction") will be adjusted for inflation.

Elderly or blind individuals.—An additional standard deduction amount of $600 is allowed for an elderly or a blind individual who is married (whether filing jointly or separately) or is a surviving spouse; the additional amount is $1,200 for such an individual who is both elderly and blind. An additional standard deduction amount of $750 is allowed for a head of household who is elderly or blind ($1,500, if both), or for a single individual (i.e., an unmarried individual other than a surviving spouse or head of household) who is elderly or blind ($1,500, if both).[3]

For elderly or blind taxpayers only, the new basic standard deduction amounts (i.e., $5,000, $4,400, $3,000, or $2,500) and the additional $600 or $750 standard deduction amounts are effective beginning in 1987. For example, for married taxpayers both of whom are 65 or older, the standard deduction in 1987 on a joint return will be $6,200. If only one spouse is 65 or older, or blind, the standard deduction in 1987 on a joint return will be $5,600. Beginning in 1989, the $600 and $750 additional standard deduction amounts will be adjusted for inflation.

Standard deduction for 1987.—For all individual taxpayers other than elderly or blind individuals, the standard deduction amounts for taxable years beginning in 1987 are $3,760 for married individuals filing jointly and surviving spouses; $2,540 for heads of household and single individuals; and $1,880 for married individuals filing separately.

As under prior law, the Internal Revenue Service will continue to prepare tax tables reflecting the tax liability of individuals who use the standard deduction. (The IRS also may prepare tax tables for taxpayers who itemize, but these tables may not incorporate the standard deduction into the tables in the way the ZBA was previously incorporated in the tax tables.) In preparing the tables, the IRS may adjust the size of the intervals between taxable income amounts in the tables to reflect meaningful differences in tax liability.

3. Personal exemption

Exemption amount.—The Act increases the personal exemption for each individual, the individual's spouse, and each eligible dependent to $1,900 for taxable years beginning during 1987, $1,950 for taxable years beginning during 1988, and $2,000 for taxable years beginning after December 31, 1988. Beginning in 1990, the $2,000 personal exemption amount will be adjusted for inflation. The Act also repeals the additional exemption for an elderly or blind individual, beginning in 1987. (As described above, the Act provides an additional standard deduction amount for an elderly or blind individual, beginning in 1987; also, the generally applicable increased standard deduction amounts apply for elderly or blind individuals beginning in 1987.)

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[3] See text below for computation of standard deduction where an elderly or blind individual is eligible to be claimed as a dependent on the tax return of another taxpayer.

Phaseout.—Beginning in 1988, the benefit of the personal exemption is phased out for taxpayers having taxable income exceeding specified levels. The income tax liability of such taxpayers is increased by five percent of taxable income within certain ranges.

This reduction in the personal exemption benefit starts at the taxable income level at which the benefit of the 15-percent rate is totally phased out (see "Rate adjustment," above). For example, in the case of married individuals filing joint returns, in 1988 the personal exemption phaseout begins at taxable income of $149,250.

The benefit of each personal exemption amount is phased out over an income range of $10,920 in 1988 and $11,200 in 1989. The phaseout occurs serially. For example, the phaseout of the benefit of the second personal exemption on a joint return does not begin until the phaseout of the first has been completed. Thus, in the case of married individuals filing jointly who have two children, in 1988 the benefit of the four personal exemptions on the joint return would phase out over an income range of $43,680 (four times $10,920) and would be phased out completely at taxable income of $192,930; in 1989, the benefit of each exemption would phase out over an income range of $44,800 (four times $11,200).

Rules for certain dependents.—The Act provides that an individual for whom a personal exemption deduction is allowable on another taxpayer's return is not entitled to any personal exemption amount on his or her own return. For example, if married individuals may claim a personal exemption deduction for their child, the child may not claim any personal exemption on his or her return.

Under prior law, the ZBA could be used by such a dependent taxpayer only to offset earned income. The Act provides that in the case of an individual for whom a personal exemption deduction is allowable on another taxpayer's return, the individual's basic standard deduction is limited to the greater of (a) $500 (to be adjusted for inflation beginning in 1989) or (b) the individual's earned income. The preceding limitation is intended to apply only with respect to the basic standard deduction, and not with respect to the additional standard deduction amount allowable to an elderly or blind individual.[4] For example, in 1987 an unmarried elderly individual (other than a surviving spouse) who may be claimed as a dependent on her son's tax return may first utilize the basic standard deduction ($3,000) to offset the greater of (1) earned income or (2) nonearned income up to $500. In addition, the individual could apply the additional standard deduction amount ($750) against any remaining income not offset by the basic standard deduction (pursuant to the rule stated in the preceding sentence), whether earned or nonearned income.

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[4] A technical correction may be needed to reflect this intent.

Under the Act, an individual who is eligible to be claimed as a dependent on another's tax return must file a Federal income tax return only if he or she either (1) has total gross income in excess of the standard deduction (including, in the case of an elderly or blind individual, the additional standard deduction amount) or (2) has nonearned income in excess of $500 plus, in the case of an elderly or blind individual, the additional standard deduction amount. For example, an elderly individual who may be claimed as a dependent on her daughter's tax return must file a return for 1987 only if the elderly individual either (1) has total gross income exceeding $3,750 or (2) has nonearned income exceeding $1,250.[5]

These rules for dependents are effective for taxable years beginning on or after January 1, 1987.

4. Adjustments for inflation

The new rate structure will be adjusted for inflation (i.e., indexed) beginning in 1989, to reflect changes in the Consumer Price Index for all-urban consumers (CPI) between the 12-month period ending on August 31, 1987 and the following 12-month period. Any inflation adjustment will apply to the breakpoint between the 15-percent and 28-percent brackets, and to the income levels above which the rate adjustment and personal exemption phaseouts apply.

Inflation adjustments will begin in 1989 to the increased standard deduction amounts that generally are effective for 1988, and to the additional standard deduction amount for blind or elderly individuals (which goes into effect in 1987). Inflation adjustments will begin in 1990 to the $2,000 personal exemption amount that applies for 1989.

Under the Act, inflation adjustments (except to the earned income credit) will be rounded down to the next lowest multiple of $50.[6] For example, an inflation rate adjustment of four percent would raise the starting point of the 28-percent bracket for 1989 returns of married individuals filing jointly from $29,750 to $30,940; this amount then would be rounded down to $30,900 for purposes of constructing the indexed rate schedule applicable to 1989.

In subsequent years, the indexing adjustment will reflect the rate of inflation for the cumulative period after the 12-month period ended August 31, 1987, with respect to the rate brackets and the increased standard deduction amounts; and August 31, 1988, with respect to the $2,000 personal exemption. As a result, while rounding down affects the inflation adjustments made in each year, there is no cumulative effect from rounding on the bracket thresholds and related amounts, since each year's inflation adjustment will be computed to reflect the cumulative rate of inflation from the initial base period. If the CPI currently published by the Department of Labor is revised, then the revision that is most consistent with the CPI for calendar year 1986 is to be used.

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[5] A technical correction may be needed to reflect this intent.

[6] In the case of a married individual filing a separate return, inflation adjustments to the bracket amounts will be rounded down to the nearest multiple of $25 (except with respect to sec. 63(c)(4)).

5. Two-earner deduction

The prior-law deduction for two-earner married couples is repealed, effective for taxable years beginning on or after January 1, 1987.

6. Income averaging

The prior-law provisions for income averaging are repealed, effective for taxable years beginning on or after January 1, 1987.

Effective Dates

Rate structure.—The transitional five-bracket tax rate schedules are effective for taxable years beginning in 1987. The two-bracket tax rate schedules and the rate adjustment are effective for taxable years beginning on or after January 1, 1988.

Standard deduction.—For taxable years beginning on or after January 1, 1987, the standard deduction replaces the ZBA. The transitional standard deduction amounts apply for taxable years beginning in 1987. The increased standard deduction amounts generally are effective for taxable years beginning on or after January 1, 1988. For elderly or blind individuals, the increased basic standard deduction amounts and the additional standard deduction amounts are effective for taxable years beginning on or after January 1, 1987.

Personal exemption.—The personal exemption amounts of $1,900, $1,950, and $2,000 apply, respectively, for taxable years beginning during 1987, taxable years beginning during 1988, and taxable years beginning after December 31, 1988. The phase-out of the personal exemption amount applies for taxable years beginning on or after January 1, 1988. The rules disallowing any exemption amount on the return of an individual who is eligible to be claimed as a dependent on another taxpayer's return are effective for taxable years beginning on or after January 1, 1987.

Inflation adjustments.—The change of the date of the 12-month measuring period for inflation adjustments to August 31 and the provision relating to rounding down inflation adjustments to the nearest $50 are effective for taxable years beginning on or after January 1, 1987.

Two-earner deduction.—The repeal of the prior-law deduction for two-earner married couples is effective for taxable years beginning on or after January 1, 1987.

Income averaging.—The repeal of the prior-law provisions for income averaging is effective for taxable years beginning on or after January 1, 1987.

Revenue Effect

Tax rates

The changes in the income tax rates are estimated to decrease fiscal year budget receipts by $16,900 million in 1987, $56,812 million in 1988, $53,725 million in 1989, $39,039 million in 1990, and $40,626 million in 1991.[7]

Standard deduction

The increases in the standard deduction amounts are estimated to decrease fiscal year budget receipts by $1,127 million in 1987, $6,183 million in 1988, $8,276 million in 1989, $8,864 million in 1990, and $9,493 million in 1991.

Personal exemption

The increase in the personal exemption amount, the repeal of the prior-law additional exemption for the elderly and blind, and the disallowance of a personal exemption for an individual who is eligible to be claimed as a dependent on another taxpayer's return are estimated to decrease fiscal year budget receipts by $13,414 million in 1987, $26,298 million in 1988, $26,530 million in 1989, $27,678 million in 1990, and $28,876 million in 1991.

Two-earner deduction

The repeal of the prior-law deduction for two-earner married couples is estimated to increase fiscal year budget receipts by $1,379 million in 1987, $6,016 million in 1988, $6,177 million in 1989, $6,572 million in 1990, and $6,995 million in 1991.

Income averaging

The repeal of the prior-law provisions for income averaging is estimated to increase fiscal year budget receipts by $430 million in 1987, $1,814 million in 1988, $1,928 million in 1989, $2,077 million in 1990, and $2,239 million in 1991.

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[7] The rate reduction estimate includes the effects relating to capital gains as well as interactions between rate changes and other provisions of the Act.

B. Earned Income Credit (Sec. 111 of the Act and secs. 32 and 3507 of the Code) [8]

Prior Law

An eligible individual who maintains a home for one or more children is allowed a refundable income tax credit based on the individual's earned income up to a specified dollar amount. The credit is available to married individuals filing a joint return who are entitled to a dependency exemption for a child, a head of household, and a surviving spouse.[9]

Under prior law, the earned income credit generally equalled 11 percent of the first $5,000 of earned income, for a maximum credit of $550 (Code sec. 32). The amount of the credit was reduced if the individual's adjusted gross income (AGI) or, if greater, earned income, exceeded $6,500; no credit was available for individuals with AGI or earned income of $11,000 or more.

To relieve eligible individuals of the burden of computing the amount of credit to be claimed on their returns, the Internal Revenue Service publishes tables for determining the credit amount. Eligible individuals may receive the benefit of the credit in their paychecks throughout the year by electing to receive advance payments.

Reasons for Change

The earned income credit is intended to provide tax relief to low-income working individuals with children and to improve incentives to work. Periodically since enactment of the credit in 1975, the Congress has increased the maximum amount and the phase-out levels of the credit to offset the effects of inflation and social security tax increases.

The Congress concluded that further increases in the maximum amount and phase-out level of the credit were necessary to offset past inflation and increases in the social security tax. In addition, the Congress believed that an automatic adjustment to the credit to reflect future inflation should be provided, just as it is provided for the personal exemption, the standard deduction, and rate brackets, in order to eliminate the reduction in the real value of the credit caused by inflation.

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[8] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 111; H.Rep. 99-426, pp. 94-95; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 111; S.Rep. 99-313, pp. 43-44; Senate floor amendment, 132 Cong. Rec. S 7969 (June 19, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 12-13 (Conference Report).

[9] For definitions of head of household and surviving spouse, see Title I., Part A., above.

Explanation of Provisions

The Act increases the rate and base of the earned income credit to 14 percent of the first $5,714 of an eligible individual's earned income. As a result, the maximum credit is increased to $800.

The income level at which the credit is completely phased out is raised to $13,500. Starting in taxable years that begin on or after January 1, 1988, the phase-out range is raised to $9,000/$17,000.

Under the Act, the credit is to be adjusted (beginning in 1987) for inflation. The adjustment factor for 1987 equals the increase in the consumer price index (CPI) from August 31, 1984, to August 31, 1986. (Thus, the maximum amount of earned income eligible for the credit beginning in 1987 equals $5,714 as adjusted for inflation between August 31, 1984 and August 31, 1986.) Subsequent annual increases are to adjust for the effects of additional annual changes in the CPI. These adjustments affect the amount of income to which the credit applies and the lower and upper limits of the phaseout range.

These inflation adjustments to the earned income credit are not subject to the $50 rounding-down rule otherwise applicable under the Act to inflation adjustments. Instead, as under the generally applicable inflation adjustment rule of prior law, any inflation adjustment relating to the credit that is not a multiple of $10 will be rounded to the nearest multiple of $10.

The Act also directs the Treasury Department to include in regulations a requirement that employers notify their employees whose wages are not subject to income tax withholding that they may be eligible for a refundable earned income credit. (The regulations are to prescribe the time and manner for such notification.) However, this notice does not have to be given to employees whose wages are exempt from withholding pursuant to Code section 3402(n). This exemption applies, for example, to many high school or college students who are employed for the summer.

Effective Date

The increases in the credit rate and base and the provisions relating to inflation adjustments are effective for taxable years beginning on or after January 1, 1987.

The increase in the beginning phase-out level to $9,000 is effective for taxable years beginning on or after January 1, 1988.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by $14 million in 1987, $309 million in 1988, $723 million in 1989, $886 million in 1990, and $1,077 million in 1991, and to increase fiscal year budget outlays by $83 million in 1987, $1,731 million in 1988, $3,149 million in 1989, $3,481 million in 1990, and $3,848 million in 1991. (To the extent that the amount of earned income credit exceeds tax liability and thus is refundable, it is treated as an outlay under budget procedures.)

C. Exclusions from Income

1. Unemployment compensation benefits (sec. 121 of the Act and sec. 85 of the Code)[10]

Prior Law

Prior law provided a limited exclusion from income for unemployment compensation benefits paid pursuant to a Federal or State program (Code sec. 85).

If the sum of the individual's unemployment compensation benefits and adjusted gross income (AGI) did not exceed a defined base amount, then no unemployment compensation benefits were included in gross income. The base amount was $18,000 in the case of married individuals filing a joint return; $12,000 in the case of an unmarried individual; and zero in the case of married individuals filing separate returns. If the sum of unemployment compensation benefits and AGI exceeded the base amount, the amount of the benefits included in gross income generally was limited to the lesser of (1) one-half the excess of the sum of such benefits plus AGI over the base amount, or (2) the amount of such benefits received.

Reasons for Change

While all cash wages and similar compensation (such as vacation pay and sick pay) received by an individual generally have been treated as fully includible in gross income under the tax law, unemployment compensation benefits were includible under prior law only if the taxpayer's AGI and benefits exceeded specified levels. The Congress concluded that unemployment compensation benefits, which essentially are wage replacement payments, should be treated for tax purposes in the same manner as wages or other wage-type payments. Thus, repeal of the prior-law partial exclusion contributes to more equal tax treatment of individuals with the same economic income. Also, if wage replacement payments are given more favorable tax treatment than wages, some individuals may be discouraged from returning to work.

Explanation of Provision

Under the Act, all unemployment compensation benefits (whether paid pursuant to a Federal or State law) received after 1986 are includible in gross income.

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[10] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 122; H.Rep. 99-426, pp. 98-99; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 121; S.Rep. 99-313, pp. 46-47; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 14 (Conference Report).

Effective Date

The provision is effective for amounts received after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $230 million in 1987, $764 million in 1988, $749 million in 1989, $723 million in 1990, and $701 million in 1991.

2. Prizes and awards (sec. 122 of the Act and secs. 74, 102, and 274 of the Code)[11]

Prior Law

Under prior and present law, prizes and awards received by an individual (other than scholarships or fellowship grants to the extent excludable under sec. 117) generally are includible in gross income. Treasury regulations provide that such taxable prizes and awards include amounts received from giveaway shows, door prizes, awards in contests of all types, and awards from an employer to an employee in recognition of some achievement in connection with employment.

However, prior-law section 74(b) provided a special exclusion from income for certain prizes and awards that were received in recognition of charitable, religious, scientific, educational, artistic, literary, or civic achievement ("charitable achievement awards"). This exclusion applied only if the recipient (1) had not specifically applied for the prize or award (for example, by entering a contest), and (2) was not required to render substantial services as a condition of receiving it. Treasury regulations stated that the section 74(b) exclusion did not apply to prizes or awards from an employer to an employee in recognition of some achievement in connection with employment.[12]

While section 74 determines the includibility in gross income of prizes and awards, the treatment of other items provided by an employer to an employee could be affected by section 61, defining gross income, and prior-law section 102, under which gifts may be excluded from gross income. Section 61 provides in part that "gross income means all income from whatever source derived," including compensation for services whether in the form of cash, fringe benefits, or similar items. However, under prior law, an item transferred from an employer to an employee, other than a prize or award that was includible under section 74, might be excludable from gross income if it qualified as a gift under section 102.

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[11] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 123(b); H.Rep. 99-426, pp. 103-07; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 122; S.Rep. 99-313, pp. 47-54; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 17-19 (Conference Report).

[12] Treas. Reg. sec. 1.74-1(b). But see *Jones* v. *Comm'r*, 743 F.2d 1429 (9th Cir. 1984), holding that an award from an employer to an employee could qualify for the prior-law section 74(b) exclusion under extraordinary circumstances. The court held that the exclusion applied in the case of a prominent scientist who was rewarded by the National Aeronautics and Space Administration (NASA) for lifetime scientific achievement, only part of which was accomplished while the scientist was employed by NASA. No inference is intended under the Act as to whether the decision in this case was a correct interpretation of section 74(b) as in effect prior to the Act.

The U.S. Supreme Court, in a 1960 case involving payments made "in a context with business overtones," defined excludable gifts as payments made out of "detached and disinterested generosity" and not in return for past or future services or from motives of anticipated benefit (*Comm'r* v. *Duberstein,* 363 U.S. 278 (1960)). Under this standard, the Court said, transfers made in connection with employment could constitute gifts only in the "extraordinary" instance.[13]

In certain circumstances, if an award to an employee could constitute an excludable gift under prior law, the employer's deduction was subject to limitation under section 274(b). That section expressly defines the term "gift" to mean any amount excludable from gross income under section 102 that is not excludable under another statutory provision.

Section 274(b) generally disallows business deductions for gifts to the extent that the total cost of all gifts of cash, tangible personal property, and other items to the same individual from the taxpayer during the taxable year exceeds $25. Under an exception to the $25 limitation provided by prior law, the ceiling on the deduction was $400 in the case of an excludable gift of an item of tangible personal property awarded to an employee for length of service, safety achievement, or productivity. In addition, the prior-law ceiling on the employer's business gift deduction was $1,600 for an excludable employee award for such purposes when provided under a qualified award plan, if the average cost of all plan awards in the year did not exceed $400.

A further rule that may be relevant with respect to a prize or award arises under section 132(e), which provides that de minimis fringe benefits are excludable from income. A de minimis fringe generally is defined as any property or service the value of which is (taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

Reasons for Change

Charitable achievement awards

A prize or award generally increases an individual's net wealth in the same manner as any other receipt of an equivalent amount that adds to the individual's economic well-being. For example, the receipt of an award of $10,000 for scientific achievement increases the recipient's net wealth and ability to pay taxes to the same extent as the receipt of $10,000 in wages, dividends, or as a taxable award; nonetheless, such an award was not treated as income under prior law. Also, as in the case of other exclusions or deductions, the tax benefit of the prior-law section 74(b) exclusion depended on the recipient's marginal tax rate, and thus generally was greater in the case of higher-income taxpayers.

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[13] Under *Duberstein*, the determination of whether property transferred from an employer to an employee (or otherwise transferred in a business context) constituted a gift to the recipient was to be made on a case-by-case basis, by an "objective inquiry" into the facts and circumstances. If the transferor's motive was "the incentive of anticipated benefit," or if the payment was in return for services rendered (whether or not the payor received an economic benefit from the payment), then the payment must be included in income by the recipient.

In light of these considerations, the Congress concluded that prizes and awards generally should be includible in gross income even if received because of achievement in fields such as the arts and sciences. This repeal of the special prior-law exclusion for certain awards was viewed as consistent with the Act's general objectives of fairness and economic neutrality.

In addition, the Congress was concerned about problems of complexity that had arisen as a result of the special prior-law exclusion under section 74(b). The questions of what constituted a qualifying form of achievement, whether an individual had initiated action to enter a contest or proceeding, and whether the conditions of receiving a prize or award involved rendering "substantial" services, had all caused some difficulty in this regard. Finally, in some circumstances the prior-law exclusion could have served as a possible vehicle for the payment of disguised compensation.

At the same time, the Congress recognized that in some instances the recipient of the type of prize or award described in section 74(b) may wish to assign the award to charity, rather than claiming it for personal consumption or use. Accordingly, the Act retains the prior-law exclusion for charitable achievement awards described in section 74(b) but only if the award is transferred by the payor, pursuant to a designation made by the winner of the prize or award, to a governmental unit or to a tax-exempt charitable, educational, religious, etc. organization contributions to which are deductible under section 170(c)(1) or section 170(c)(2), respectively.

Employee awards

An additional reason for change relates to the prior-law tax treatment of employee awards of tangible personal property given by reason of length of service, safety achievement, or productivity. Except for any item that might be able to qualify as a de minimis fringe benefit as defined by section 132(e), such employee awards were not excludable from the employee's gross income, and the deduction of their cost by the employer was not limited under section 274(b), if they could not qualify as gifts because of either the "detached generosity" standard applicable under section 102 or the rule of section 74(a) that prizes and awards generally are includible in income.

The Congress understood that uncertainty had arisen among some taxpayers concerning the proper tax treatment under prior law of an employee award. Such uncertainty could lead some employers to seek to replace amounts of taxable compensation (such as sales bonuses) with "award" programs of tangible personal property. The business and the employee might contend that such awards are not subject to income or social security taxes, but that the employer could still deduct the costs of the awards up to the section 274(b) limitations. In the case of highly compensated employees, who often might not be significantly inconvenienced by the fact that such awards would be made in the form of property rather than cash, an exclusion for transfers of property with respect to regular job performance (such as for productivity) could serve as a means of providing tax-free compensation. As in the case of other exclusions or deductions, the tax benefit of such an exclusion for transfers to an employee would depend on the recipient's marginal tax rate, and thus generally would be greater for higher-income employees.

Accordingly, the Congress believed that it was desirable to provide express rules with regard to the tax treatment of amounts transferred by or for an employer to or for the benefit of an employee. The Congress concluded that, in general, an award to an employee from his or her employer does not constitute a "gift" comparable to such excludable items as intrafamily holiday gifts, and should be included in the employee's gross income for income tax purposes and in wages for withholding and employment tax purposes.

However, the Congress believed that no serious potential for avoiding taxation on compensation arises from transfers by employers to employees of items of minimal value. Therefore, the Congress wished to clarify that the section 132(e) exclusion for de minimis fringe benefits can apply to employee awards of low value. The Congress also concluded that this exclusion should be viewed as applicable to traditional awards (such as a gold watch) upon retirement after lengthy service for an employer. For example, in the case of an employee who has worked for an employer for 25 years, a retirement gift of a gold watch may qualify for exclusion as a de minimis fringe benefit even though gold watches given throughout the period of employment would not so qualify for exclusion. In that case, the award is not made in recognition of any particular achievement, relates to many years of employment, and does not reflect any expectation of or incentive for the recipient's rendering of future services.

Also, the Congress concluded that, in certain narrowly defined circumstanes, it is appropriate to recognize traditional business practices of making awards of tangible personal property for length of service or safety achievement. These traditional practices may involve, for example, awards of items that identify or symbolize the awarding employer or the achievement being recognized, and that do not merely provide an economic benefit to the employee. Such practices were not entirely equivalent, for example, to providing either a bonus in cash or an allowance of a dollar amount toward the purchase of ordinary merchandise. The Congress believed that the double income tax benefit of excludability and deductibility is acceptable for such types of employee achievement awards under rules intended to prevent abuse and limit the scope of the double benefit.

In light of these considerations, the Act restricts the double benefit through dollar limitations, limits the frequency with which length of service awards can be made to the same employee, and limits safety achievement awards to the employer's work force (other than administrators, professionals, etc. whose work ordinarily does not involve significant safety concerns) and to no more than 10 percent of such eligible recipients in one year. In addition, the exclusion applies only if the item of tangible personal property is awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.

The Act removes the prior-law uncertainty concerning the tax treatment of some employee awards by making clear that the fair market value of any employee award that does not constitute either a length of service award or a safety achievement award qualifying under the Act or a de minimis fringe benefit described in section 132(e)(1) is includible in gross income for income tax purposes and in wages or compensation for employment tax and withholding purposes. The Congress believed that this general rule of includibility is consistent with the Act's objectives of fairness and economic neutrality.

Explanation of Provisions

Charitable achievement awards

Under the Act, the prior-law limited exclusion under section 74(b) for a prize or award for certain charitable, religious, scientific, educational, artistic, literary, or civic achievement (a "charitable achievement award") is further restricted to apply only if the recipient designates that the award is to be transferred by the payor to a governmental unit or a tax-exempt charitable, educational, religious, etc. organization that is eligible to receive contributions that are deductible under sections 170(c)(1) or 170(c)(2), respectively. If such designation is made and if the charitable achievement award is so transferred to the designated governmental unit or charitable organization by the payor, the award is not included in the winner's gross income, and no charitable deduction is allowed either to the winner or to the payor on account of the transfer to the governmental unit or charitable organization.

For purposes of determining whether a charitable achievement award that is so transferred qualifies as excludable under the Act, the prior-law rules concerning the scope of section 74(b) are retained without change. (Thus, for example, the exclusion is available only if the award winner had not specifically applied for the award, and was not required to render substantial services as a condition of receiving it.) In addition, in order to qualify for the section 74(b) exclusion as modified by the Act, the designation must be made by the taxpayer (the award recipient), and must be carried out by the party making the prize or award, before the taxpayer uses the item that is awarded (e.g., in the case of an award of money, before the taxpayer spends, deposits, invests, or otherwise uses the money)

Disqualifying uses by the taxpayer include such uses of the property with the permission of the taxpayer or by one associated with the taxpayer (e.g., a member of the taxpayer's family). Absent a disqualifying use, however, the taxpayer can make the required designation of the governmental unit or charitable organization (to which the award is to be transferred by the payor) after receipt of the prize or award.

Employee awards

In general

The Act provides an exclusion from gross income (Code sec. 74(c)), subject to certain dollar limitations, for an "employee achievement award" that satisfies the requirements set forth in the Act. The Act defines an employee achievement award (Code sec. 274(j)) as an item of tangible personal property transferred by an employer to an employee for length of service achievement or for safety achievement,[14] but only if the item (1) is awarded as part of a meaningful presentation, and (2) is awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.[15] The exclusion applies only for awards of tangible personal property and is not available for awards of cash, gift certificates, or equivalent items, or for awards of intangible property or real property.

An award for length of service cannot qualify for the exclusion if it is received during the employee's first five years of employment for the employer making the award, or if the employee has received a length of service achievement award (other than an award excludable under sec. 132(e)(1)) from the employer during the year or any of the preceding four years. An award for safety achievement cannot qualify for the exclusion if made to an individual who is not an eligible employee, or if, during the taxable year, employee awards for safety achievement (other than awards excludable under sec. 132(e)(1)) have previously been awarded by the employer to more than 10 percent of the employer's eligible employees. That is, no more than 10 percent of an employer's eligible employees may receive excludable safety achievement awards in any taxable year (even if all the awards are made simultaneously).[16] For this purpose, eligible employees are all employees of the taxpayer other than managers, administrators, clerical workers, and other professional employees.

Deduction limitations

Under section 274 as amended by the Act, an employer's deduction for the cost of all employee achievement awards (both safety and length of service) provided to the same employee during the taxable year generally cannot exceed $400. In the case of one or more qualified plan awards awarded to the same employee during the taxable year, however, the employer's deduction limitation for all such qualified plan awards (both safety and length of service) is $1,600. In addition to these separate $400/$1,600 limitations, the $1,600 limitation applies in the aggregate if during the year an employee receives one or more qualified plan awards and also one or more employee achievement awards that are not qualified plan awards; i.e., the $400 and $1,600 limitations cannot be added together to allow deductions exceeding $1,600 in the aggregate for employee achievement awards made to the same employee in a taxable year.[17]

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[14] Thus, an employee award for productivity, or for any other purpose not specified in sec. 274(j), is not excludable under sec. 74(c).

[15] The types of conditions and circumstances that are to be deemed to create a significant likelihood of payment of disguised compensation include, for example, the making of employee awards at the time of annual salary adjustments or as a substitute for a prior program of awarding cash bonuses, or the providing of employee awards in a way that discriminates in favor of highly paid employees.

[16] Accordingly, no exclusion for safety achievement awards is available in the case of an employer with nine or fewer eligible employees.

A qualified plan award is defined as an employee achievement award provided under a qualified award plan, i.e., an established, written plan or program of the taxpayer that does not discriminate in favor of highly compensated employees (within the meaning of sec. 414(q)) as to eligibility or benefits. However, an item cannot be treated as a qualified plan award if the average cost per recipient of all employee achievement awards made under all qualified award plans of the employer during the taxable year exceeds $400. In making this calculation of average cost, qualified plan awards of nominal value are not to be included in the calculation (i.e., are not to be added into the total of award costs under the plan in computing average cost). In the case of a qualified plan award the cost of which exceeds $1,600, the entire cost of the item is to be added into the total of qualified plan award costs in computing average cost, notwithstanding that only $1,600 (or less) of such cost is deductible.

Excludable amount

In the case of an employee achievement award the cost of which is deductible in full by the employer under the dollar limitations of section 274 (as amended by the Act),[18] the fair market value of the award is fully excludable from gross income by the employee. For example, assume that an employer makes a length of service achievement award (other than a qualified plan award) to an employee in the form of a crystal bowl, that the employer makes no other length of service awards or safety achievement awards to that employee in the same year, and that the employee has not received a length of service award from the employer during the prior four years. Assume further that the cost of the bowl to the employer is $375, and that the fair market value of the bowl is $415. The full fair market value of $415 is excludable from the employee's gross income for income tax purposes under section 74 as amended by the Act.

However, if any part of the cost of an employee achievement award exceeds the amount allowable as a deduction by an employer because of the dollar limitations of section 274, then the exclusion does not apply to the entire fair market value of the award. In such a case, the employee must include in gross income the greater of (i) an amount equal to the portion of the cost to the employer of the award that is not allowable as a deduction to the employer (but not an amount in excess of the fair market value of the award) or (ii) the amount by which the fair market value of the award exceeds the maximum dollar amount allowable as a deduction to the employer. The remaining portion of the fair market value of the award is not included in the employee's gross income for income tax purposes.

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[17] In the case of an employee award provided by a partnership, the deduction limitations of section 274(j) apply to the partnership as well as to each partner. The new employee achievement award exclusion is not available for any award made by a sole proprietorship to the sole proprietor; consequently, the deduction limitations in sec. 274(j) do not apply with respect to such an includible award.

[18] In the case of a tax-exempt employer, the deduction limitation amount is that amount that would be deductible if the employer were not exempt from taxation (sec. 74(c)(3)).

Consider, for example, the case of a safety achievement award to an eligible employee that is not a qualified plan award, and that costs the employer $500; assume that no other employee achievement awards were made to the same employee during the taxable year, and that safety achievement awards were not awarded during the year to more than 10 percent of eligible employees of the employer. The employer's deduction is limited to $400. The amount includible in gross income by the employee is the greater of (1) $100 (the difference between the item's cost and the deduction limitation), or (2) the amount by which the item's fair market value exceeds the deduction limitation. If the fair market value equals, for example, $475, then $100 is includible in the employee's income. If the fair market value equals $600, then $200 is includible in the employee's income.

Except to the extent that the new section 74(c) exclusion or section 132(e)(1) applies, the fair market value of an employee award (whether or not satisfying the definition of an employee achievement award) is includible in the employee's gross income under section 61, and is not excludable under section 74 (as amended by the Act). Also, the Act amends section 102 to provide explicitly that the section 102 exclusion for gifts does not apply to any amount transferred by or for an employer to, or for the benefit of, an employee. The fair market value of an employee award (or any portion thereof) that is not excludable from gross income must be included by the employer on the employee's Form W-2, as was required under prior law.

Any amount of an employee achievement award that is excludable from gross income under the Act also is excludable from wages or compensation for employment tax (e.g., FICA tax) purposes and is excludable from the social security benefit base.

The Act does not modify Code section 132(e)(1), under which de minimis fringe benefits are excluded from gross income. Thus, an employee award is not includible in income if its fair market value, after taking into account the frequency with which similar benefits are provided by the employer to the employer's employees, is so small as to make accounting for it unreasonable or administratively impracticable. For example, the section 132(e)(1) exclusion would apply with respect to a pin or similar item with a value of $15 awarded to an employee on joining a business, on completing six months' employment, or on completing a probationary employment period.

As noted above, for purposes of section 274 (as modified by the Act), an employee award that is excludable under section 132(e)(1) is disregarded in applying the rules regarding how frequently an individual may receive an excludable length of service award, or how many employees of an employer may receive an excludable safety achievement award in the same taxable year. Under appropriate circumstances, however, the fact that an employer makes a practice of giving its employees length of service or safety achievement awards that qualify under section 74 and 274 may affect the question of whether other items given to such employees (particularly if given by reason of length of service or safety achievement) qualify as de minimis fringe benefits under section 132(e)(1).

The question of whether it is unreasonable or administratively impracticable (within the meaning of sec. 132(e)(1)) to account for an item may be affected by the existence of a program whereby the taxpayer regularly accounts for other like items and complies with the statutory reporting requirements. Moreover, in some cases the fact that a particular employee receives items having the maximum fair market value consistent, respectively, with the employee achievement award and the de minimis fringe benefit exclusions may suggest that the employer's practice is not de minimis. This is particularly so when employee awards and other items, purportedly within the scope of section 132(e)(1), are provided to the same individual in the same year.

The Congress intended that the exclusion under section 132(e)(1) for a de minimis fringe benefit is to apply, under appropriate circumstances, to traditional retirement gifts presented to an employee on his or her retirement after completing lengthy service, even if the section 74(c) exclusion for length of service awards does not apply because the employee received such an award within the prior four years. In considering whether an item presented upon retirement so qualifies, the duration of the employee's tenure with the employer generally has relevance. For example, in the case of an employee who has worked for an employer for 25 years, a retirement gift of a gold watch may qualify for exclusion as a de minimis fringe benefit even though gold watches given throughout the period of employment would not so qualify for that exclusion.

Effective Date

The provisions relating to the tax treatment of prizes and awards are effective for prizes and awards granted after December 31, 1986.

Revenue Effect

The provisions relating to the tax treatment of prizes and awards are estimated to decrease fiscal year budget receipts by $21 million in 1987, $59 million in 1988, $63 million in 1989, $66 million in 1990, and $69 million in 1991.

3. Scholarships and fellowships (sec. 123 of the Act and sec. 117 of the Code) [19]

Prior Law

In general

Prior law generally provided an unlimited exclusion from gross income for (1) amounts received by a degree candidate as a scholarship at an educational institution (described in sec. 170(b)(1)(A)(ii)), or as a fellowship grant, and (2) incidental amounts received by such individual and spent for travel, research, clerical help, or equipment (sec. 117). The term scholarship meant an amount paid or allowed to, or for the benefit of, a student to aid in pursuing studies; similarly, a fellowship grant was defined as an amount paid or allowed to, or for the benefit of, an individual to aid in pursuing studies or research (Treas. Reg. sec. 1.117-3).

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[19] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 123; H.Rep. 99-426, pp. 99-103; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 14-17 (Conference Report).

In the case of an individual who was not a candidate for a degree, the prior-law exclusion was available only if the grantor of the scholarship or fellowship was an educational institution or other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. The prior-law exclusion for a nondegree candidate in any one year could not exceed $300 times the number of months in the year for which the recipient received scholarship or fellowship grant amounts, and no further exclusion was allowed after the nondegree candidate had claimed exclusions for a total of 36 months (i.e., a maximum lifetime exclusion of $10,800). However, this dollar limitation did not apply to that portion of the scholarship or fellowship received by the nondegree candidate for travel, research, clerical help, or equipment.

Under prior and present law, an educational institution is described in section 170(b)(1)(A)(ii) if it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. This definition encompasses primary and secondary schools, colleges and universities, and technical schools, mechanical schools, and similar institutions, but does not include noneducational institutions, on-the-job training, correspondence schools, and so forth (Treas. Reg. secs. 1.117-3(b); 1.151-3(c)). Under prior law, the term candidate for a degree was defined as (1) an undergraduate or graduate student at a college or university who was pursuing studies or conducting research to meet the requirements for an academic or professional degree and (2) a student who received a scholarship for study at a secondary school or other educational institution (Treas. Reg. sec. 1.117-3(e)).

Payments for services

Under prior and present law, amounts paid to an individual to enable him or her to pursue studies or research are not excludable from income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Treas. Reg. sec. 1.117-4(c)). These regulations have been upheld by the U.S. Supreme Court, which described excludable grants as "relatively disinterested, 'no-strings' educational grants, with no requirement of any substantial quid pro quo from the recipients" (*Bingler* v. *Johnson*, 394 U.S. 741 (1969)).

In the case of degree candidates, prior law also specifically provided that the exclusion did not apply to any portion of an otherwise qualifying scholarship or fellowship grant that represented payment for teaching, research, or other services in the nature of part-time employment required as a condition of receiving the scholarship or fellowship grant (prior-law sec. 117(b)(1)). However, an exception under prior law provided that such services would not be treated as employment for this purpose if all degree candidates had to perform such services; in that case, the recipient could exclude the portion of the scholarship or fellowship grant representing compensation for such services.

Under another prior-law exception, amounts received by an individual as a grant under a Federal program that would be excludable from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future services as a Federal employee, were not includible in gross income if the individual established that the amount was used for qualified tuition and related expenses (prior-law sec. 117(c)).

Tuition reduction plans

Section 117(d) provides that a reduction in tuition provided to an employee of an educational institution is excluded from gross income if (1) the tuition is for education below the graduate level provided by the employer or by another educational institution; (2) the education is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and (3) certain nondiscrimination requirements are met. P.L. 98-611 provided that, for taxable years beginning after December 31, 1983 and ending on or before December 31, 1985, the section 117(d) exclusion also applied to qualified tuition reduction for graduate-level education provided by an educational institution to a graduate student who was employed by that institution in teaching or research activities (Code sec. 127(c)(8)).

Reasons for Change

By extending the exclusion for scholarships or fellowship grants to cover amounts used by degree candidates for regular living expenses (such as meals and lodging), prior law provided a tax benefit not directly related to educational activities. By contrast, students who are not scholarship recipients must pay for such expenses out of after-tax dollars, just as individuals who are not students must pay for their food and housing costs out of wages or other earnings that are includible in income. The Congress concluded that the exclusion for scholarships should be targeted specifically for the purpose of educational benefits, and should not encompass other items that would otherwise constitute nondeductible personal expenses. The Congress also determined that, in the case of grants to nondegree candidates for travel, research, etc., that would be deductible as ordinary and necessary business expenses, an exclusion for such expenses is not needed, and that an exclusion is not appropriate if the expenses would not be deductible.

In addition, under the Act, the Congress has increased the tax threshold, i.e., the income level at which individuals become subject to tax. Thus, the receipt of a nonexcludable scholarship amount by a student without other significant income will not result in tax liability so long as the individual's total income does not exceed the personal exemption (if available) and either the increased standard deduction under the Act or the taxpayer's itemized deductions. Under the Act, any nonexcludable amount of a scholarship or fellowship grant is treated as earned income, so that such amount can be offset by the recipient's standard deduction even if the recipient can be claimed as a dependent on his or her parents' return.

Under prior law, controversies arose between taxpayers and the Internal Revenue Service over whether a particular stipend made in an educational setting constituted a scholarship or compensation for services. In particular, numerous court cases have involved resident physicians and graduate teaching fellows who have sought—often notwithstanding substantial case authority to the contrary—to exclude from income payments received for caring for hospitalized patients, for teaching undergraduate college students, or for doing research which inures to the benefit of the grantor.[20] The limitation on the section 117 exclusion made by the Act, and the repeal of the special rule relating to degree candidates who must perform services as a condition of receiving a degree, should lessen these problems of complexity, uncertainty of tax treatment, and controversy.

The Congress concluded that the section 117 exclusion should not apply to amounts representing payment for teaching, research, or other services by a student, whether or not required as a condition for receiving a scholarship or tuition reduction, and that this result should apply whether the compensation takes the form of cash, which the student can use to pay tuition, or of a tuition reduction, pursuant to which there is no exchange of cash for payment of tuition. Thus, where cash stipends received by a student who performs services would not be excludable under the Act as a scholarship even if the stipend is used to pay tuition, the Congress believed that the exclusion should not become available merely because the compensation takes the form of a tuition reduction otherwise qualifying under section 117(d). The Congress concluded, consistently with the overall objectives of the Act, that principles of fairness require that all compensation should be given the same tax treatment; that is, some individuals (e.g., students who perform teaching services for universities) should not receive more favorable tax treatment of their compensation than all other individuals who earn wages.

The Congress concluded that it was inappropriate under prior law for recipients of certain Federal grants who were required to perform future services as Federal employees to obtain special tax treatment which was not available to recipients of other types of grants who were required to perform services as a condition of receiving the grants. Thus, under the Act, the general exclusion rule and the limitations apply equally to all grant recipients.

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[20] As the U.S. Tax Court stated in one case: "Interns and residents have been flooding the courts for years seeking to have their remuneration declared a 'fellowship grant' and hence partially excludable from income. They have advanced such illuminating arguments as they could have earned more elsewhere and they were enjoying a learning experience so therefore what they did receive must have been a grant. They have been almost universally unsuccessful and deservedly so. Why the amounts received by a young doctor just out of school should be treated differently from the amounts received by a young lawyer, engineer, or business school graduate has never been made clear." (*Zonkerman* v. *Comm'r*, 36 T.C.M. 6, 9 (1977), aff'd (4th Cir. 1978))

Explanation of Provisions

In general

Degree candidates.—In the case of a scholarship or fellowship grant received by a degree candidate, an exclusion under section 117 is available only to the extent the individual establishes that, in accordance with the conditions of the grant, the grant was used for (1) tuition and fees required for enrollment or attendance of the student at an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)), and (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution ("course-related expenses").[21] This rule applies to all types of scholarship or fellowship grants, whether funded by a governmental agency, college or university, charitable organization, business, or other source, and whether designated as a scholarship or by some other name (e.g., "allowance").

The exclusion available under the Act for degree candidates is not limited to a scholarship or fellowship grant that by its express terms is required to be used for tuition or course-related expenses. Also, there is no requirement that the student be able to trace the dollars paid for tuition or course-related expenses to the same dollars that previously had been deposited in his or her checking account, for example, from a scholarship grant check. Instead, the amount of an otherwise qualified grant awarded to a degree candidate is excludable (after taking into account the amount of any other grant or grants awarded to the individual that also are eligible for exclusion) up to the aggregate amount incurred by the candidate for tuition and course-related expenses during the period to which the grant applies; any excess amount of the grant is includible in income. No amount of a grant is excludable if the terms of the grant earmark or designate its use for purposes other than tuition or course-related expenses (such as for room or board, or "meal allowances") or specify that the grant cannot be used for tuition or course-related expenses, even if the amount of such grant is less than the amount payable by the student for tuition or course-related expenses.

For purposes of the section 117 exclusion as modified by the Act, the term candidate for a degree means (1) a student who receives a scholarship for study at a primary or secondary school, (2) an undergraduate or graduate student at a college or university who is pursuing studies or conducting research to meet the requirements for an academic or professional degree, and (3) a student (whether full-time or part-time) who receives a scholarship for study at an educational institution (described in sec. 170(b)(1)(A)(ii)) that (1) provides an educational program that is acceptable for full credit toward a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation, and (2) is authorized under Federal or State law to provide such a program and is accredited by a nationally recognized accreditation agency.

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[21] Two Code provisions applicable to private foundations contain references to scholarship or fellowship grants "subject to the provisions of section 117(a)" (secs. 4941(d)(2)(G)(ii); 4945(g)(1)). The amendments made by the Act to the section 117 exclusion are not intended to treat scholarship or fellowship grants by a private foundation that would not have triggered section 4941 or 4945 excise taxes under prior law as self-dealing acts or taxable expenditures merely because such grants exceed the amount excludable by degree candidates under section 117 as amended by the Act or are made to nondegree candidates (up to the amount excludable under prior law). A technical amendment may be needed so that the statute reflects this intent.

Nondegree candidates.—The Act repeals the limited prior-law exclusion under section 117 for grants received by nondegree candidates. Thus, no amount of a scholarship or fellowship grant received by an individual who is not a degree candidate is excludable under section 117, whether or not such amount is used for or is less than the recipient's tuition and course-related expenses. This provision does not affect whether the exclusion under section 127 for certain educational assistance benefits may apply to employer-provided educational assistance to nondegree candidates if the requirements of that section are met (see sec. 1162 of the Act, extending the exclusion under Code sec. 127), or whether unreimbursed educational expenses of some nondegree candidates may be allowable to itemizers as trade or business expenses if the requirements of section 162 are met.

Performance of services

The Act repeals the special rule of prior law under which scholarship or fellowship grants received by degree candidates that represented payment for services nonetheless were deemed excludable from income provided that all candidates for the particular degree were required to perform such services. The Act expressly includes in gross income any portion of amounts received as a scholarship or fellowship grant that represent payment for teaching, research, or other services required as a condition of receiving the grant (Code sec. 117(c)).

To prevent circumvention of the rule set forth in section 117(c), that rule is intended to apply not only to cash amounts received, but also to amounts (representing payment for services) by which the tuition of the person who performs services is reduced, whether or not pursuant to a tuition reduction plan described in Code section 117(d). The Act therefore explicitly provides that neither the section 117(a) exclusion nor the section 117(d) exclusion applies to any portion of the amount received that represents payment for teaching, research, or other services by the student required as a condition of receiving the scholarship or tuition reduction. If an amount representing reasonable compensation (whether paid in cash or as tuition reduction) for services performed by an employee is included in the employee's gross income and wages, then any additional amount of scholarship award or tuition reduction remains eligible for the section 117 exclusion as modified by the Act.

As noted, employees who perform required services for which they include in income reasonable compensation continue to be eligible to exclude amounts of tuition reduction. In addition, section 1162 of the Act extends the availability of the tuition reduction exclusion for certain graduate students an additional two taxable years beyond its previously scheduled expiration for taxable years beginning after December 31, 1985, as part of the extension of Code section 127 under the Act.

The Act also repeals the special rule under prior law that permitted the exclusion of certain Federal grants as scholarships or fellowship grants, even though the recipient was required to perform future services as a Federal employee. Thus, any portion of a Federal scholarship or fellowship grant that represents payment for past, present, or future services required to be performed as a condition of the grant is includible in gross income. As a result, services performed as a Federal employee are not entitled to more favorable tax treatment than services performed for other employers.

Treatment of nonexcludable amounts

Under the Act, a child eligible to be claimed as a dependent on the return of his or her parents may use the standard deduction only to offset the greater of $500 or earned income (see I.A.3., above). Only for purposes of that rule, any amount of a noncompensatory scholarship or fellowship grant that is includible in gross income as a result of the amendments to section 117 made by the Act (including the repeal of any sec. 117 exclusion for nondegree candidates) constitutes earned income.[22]

Compliance with new rules

Under the Act, the IRS is not required to exercise its authority to require information reporting by grantors of scholarship or fellowship grants to the grant recipients or the IRS, even though some amounts of such grants may be includible in gross income under section 117(a) as amended by the Act. (Of course, any amount of a grant that constitutes payment for services described in sec. 117(c) is subject to income tax withholding, employment taxes, and reporting requirements applicable to other forms of compensation paid by the payor organization.) The Congress anticipated that the IRS will carefully monitor the extent of compliance by grant recipients with the new rules and will provide for appropriate information reporting if necessary to accomplish compliance.

Effective Date

The modifications made by the provision are effective for taxable years beginning on or after January 1, 1987, except that prior law continues to apply to any scholarship or fellowship granted before August 17, 1986.[23] Under this rule, in the case of a scholarship or fellowship granted after August 16, 1986 and before January 1, 1987, any amount of such scholarship or fellowship grant that is received prior to January 1, 1987 and that is attributable to expenditures incurred prior to January 1, 1987 is subject to the provisions of section 117 as in effect prior to the amendments made by the Act.

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[22] Amounts received as payment for teaching or other services also constitute earned income.

[23] For this purpose, a scholarship or fellowship is to be treated as granted before August 17, 1986 to the extent that the grantor made a firm commitment, in the notice of award made before that date, to provide the recipient with a fixed cash amount or a readily determinable amount. If the scholarship or fellowship is granted for a period exceeding one academic period (e.g., if the grant is made for three semesters), amounts received in subsequent academic periods are to be treated as granted before August 17, 1986 only if (1) the amount awarded for the first academic period is described in the original notice of award as a fixed cash amount or readily determinable amount, (2) the original notice of award contains a firm commitment by the grantor to provide the scholarship or fellowship amount for more than one academic period, and (3) the recipient is not required to reapply to the grantor in order to receive the scholarship or fellowship grant in future academic periods. A requirement that the recipient must file periodic financial statements to show continuing financial need does not constitute a requirement to reapply for the grant.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $8 million in 1987, $64 million in 1988, $130 million in 1989, $160 million in 1990, and $164 million in 1991.

D. Deductions for Personal Expenditures

1. Disallowance of itemized deduction for State and local sales taxes (sec. 134 of the Act and sec. 164 of the Code)[24]

Prior Law

Itemized deduction

Under prior-law section 164, itemizers could deduct four types of State and local taxes even if such taxes had not been incurred either in a trade or business (sec. 162) or in an investment activity (sec. 212)—individual income taxes, real property taxes, personal property taxes, and general sales taxes.

Not all sales taxes imposed by State or local governments were deductible by itemizers under prior law. To be deductible, the sales tax had to be imposed on sales (either of property or of services) at the retail level.[25] In addition, to be deductible the sales tax generally had to apply at one rate to a broad range of items. However, deductions were allowed for (1) sales taxes imposed at a lower rate on food, clothing, medical supplies, and motor vehicles, and (2) sales taxes imposed at a higher rate on motor vehicles, but only up to the amount computed using the generally applicable sales tax rate.

As an exception to the general tax principle that a taxpayer has the burden of providing its entitlement to a deduction,[26] itemizers were permitted to claim deductions for sales tax amounts derived from IRS-published tables. These tables contained State-by-State estimates of sales tax liability for individuals at different income levels (calculated by including nontaxable receipts as well as adjusted gross income), taking into account the number of individuals in the taxpayer's household.[27] Also, taxpayers generally could add to the table amount the actual State and local sales taxes paid on purchases of a boat, airplane, motor vehicle, and certain other large items.

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[24] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 135; S.Rep. 99-313, pp. 55-57; Senate floor amendment, 132 Cong. Rec. S 7893-98 (June 19, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 20 (Conference Report).

[25] This test could be satisfied in the case of a compensating use tax, i.e., a tax on the use, consumption, or storage of an item that would have been subject to a general sales tax if sold in the State or locality imposing the use tax.

[26] See. e.g., *Helvering* v. *Taylor*, 293 U.S. 507, 514 (1935).

[27] Local sales taxes also are imposed in various States. An additional amount for local taxes was built into the IRS-published tables for some of these jurisdictions. For other States having local sales taxes, a further computation had to be made after deriving the table amount (e.g., itemizers in one State were allowed to increase the table amount by sales taxes imposed on electricity or gas during certain months of the year).

Capitalization rule

Under prior law, section 164(a) provided (in the last sentence of that subsection) that, in addition to the four types of State, local, and foreign taxes (enumerated in that section) for which itemized deductions were allowed, other State, local, and foreign taxes were deductible if paid or accrued in the taxable year in carrying on a trade or business or an investment-type activity described in section 212. However, a specific provision of the Code (for example, sec. 189 or sec. 263) might require capitalization of certain otherwise deductible taxes.

Reasons for Change

Itemized deduction

The Congress concluded that, as part of the approach of the Act in reducing tax rates through base-broadening, it is appropriate to disallow the itemized deduction for State and local sales taxes. In addition, a number of other considerations supported repeal of this deduction.

Prior law did not permit itemized deductions for various types of State and local sales taxes, such as selective sales taxes on telephone and other utility services, admissions, and sales of alcoholic beverages, tobacco, and gasoline. Also, prior law did not allow consumers any deduction to reflect inclusion, in the selling price of a product, of taxes levied at the wholesale or manufacturer's level. Accordingly, the Congress concluded that extending nondeductibility to all State and local sales taxes improves the consistency of Federal tax policy, by not providing an income tax benefit for any type of consumption subject to sales taxes. Further, to the extent that sales taxes are costs of purchasing consumer products or other items representing voluntary purchases, allowing the deduction was unfair because it favored taxpayers with particular consumption patterns, and was inconsistent with the general rule that costs of personal consumption by individuals are nondeductible.

The Congress did not find persuasive evidence for arguments that eliminating the sales tax deduction could provide unwarranted encouragement for States to shift away from these taxes and could be unfair to States that retain them. On the contrary, it is significant how small a portion of general sales taxes paid by individuals actually were claimed as itemized deductions. Data from 1984 show that less than one-quarter of all such sales taxes levied were claimed as itemized deductions; by contrast, well over one-half of State and local income taxes paid by individuals are claimed as itemized deductions. The Congress believed that the fact that the large majority of sales tax payments were not claimed as itemized deductions under prior law alleviates any effect of repealing the deduction on the regional distribution of Federal income tax burdens or on the willingness of State and local governments to use general sales taxes as revenue sources.

For itemizers who did not rely on the IRS-published tables to estimate their deductible sales taxes, the prior-law deduction for sales taxes involved substantial recordkeeping and computational burdens, since the taxpayer had to determine which sales taxes were deductible, keep receipts or invoices showing the exact tax paid on each purchase, and calculate the total of all deductible sales taxes paid. Also, allowing State and local sales taxes to be deducted had created legal controversies between taxpayers and the IRS regarding what was a general, as opposed to a specific, sales tax. Thus, repealing the deduction advanced the goal of simplifying the tax system for individuals.

For itemizers who did rely on the IRS tables, the amount of deductions that could be claimed under prior law without challenge from the IRS could vary significantly in particular instances from the amount of general sales taxes actually paid to State and local governments. The tables did not provide accurate estimates for individuals who had either lower or higher levels of consumption than the average, and did not reflect the fact that an individual might purchase items in several States having different general sales tax rates. Accordingly, use of the tables neither accurately measured the amount of disposable income an individual retained after paying general sales taxes, nor accurately provided an appropriate Federal tax benefit to residents of States that impose general sales taxes.

Capitalization rules

The Congress concluded that the tax treatment of sales and other taxes incurred in a business or investment activity (but not expressly enumerated as deductible under sec. 164) should be consistent with the tax treatment of other costs of capital assets. Thus, for example, the amount of sales tax paid by a business on acquisition of depreciable property for use in the business is treated under the Act as part of the cost of the acquired property for depreciation purposes.

Explanation of Provisions

Itemized deduction

The Act repeals the prior-law itemized deduction for State and local sales taxes under section 164.

Capitalization rule

The Act adds a limitation to the effect of the provision (under prior law, set forth as the last sentence of sec. 164(a)) with respect to deductibility of State and local, or foreign, taxes incurred in a trade or business or in a section 212 activity. This new limitation does not affect deductibility of the six types of taxes listed in the first sentence of section 164(a): (1) State and local, and foreign, real property taxes; (2) State and local personal property taxes; (3) State and local, and foreign, income, war profits, and excess profits taxes; (4) the windfall profit tax (sec. 4986); (5) the environmental tax (sec. 59A); and (6) the generation-skipping transfer tax imposed on income distributions. (The deductibility or capitalization of these enumerated categories of taxes may be modified by provisions in Title VIII of the Act.)

Under the Act, if a State, local, or foreign tax (other than one of the enumerated categories) paid or accrued in carrying on a trade or business or a section 212 activity is paid or accrued by the taxpayer in connection with the acquisition or disposition of property, the tax shall be treated, respectively, as a part of the cost of the acquired property or as a reduction in the amount realized on the disposition. This limitation does not apply to such a tax if not incurred by a taxpayer in connection with the acquisition or disposition of property; e.g., sales taxes on restaurant meals that are paid by the taxpayer as part of a deductible business meal are deductible (subject to the business meal reduction rule described in I.E., below).

Effective Date

The provisions are effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $968 million in 1987, $5,197 million in 1988, $4,708 million in 1989, $4,907 million in 1990, and $5,131 million in 1991.

2. Increased floor for itemized deduction for medical expenses (sec. 133 of the Act and sec. 213 of the Code)[28]

Prior Law

In general

Individuals who itemize deductions may deduct amounts paid during the taxable year (if not reimbursed by insurance or otherwise) for medical care of the taxpayer and of the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds a floor (sec. 213). Under prior law, the floor was five percent of the taxpayer's adjusted gross income.

Medical care expenses eligible for the deduction are amounts paid by the taxpayer for (1) health insurance (including employee contributions to employer health plans); (2) diagnosis, cure, mitigation, treatment, or prevention of disease or for the purpose of affecting any structure or function of the body; (3) transportation primarily for and essential to medical care; and (4) lodging while away from home primarily for and essential to medical care, subject to certain limitations. The cost of medicine or a drug qualifies as a medical care expense only if it is a prescription drug or is insulin.

Capital expenditures

Treasury regulations provide that the total cost of an unreimbursed capital expenditure may be deductible in the year of acquisition as a medical expense if its primary purpose is the medical care of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent (Reg. sec. 1.213-1(e)(1)(iii)). Qualified capital expenditures may include eyeglasses or contact lenses, hearing aids, motorized chairs, crutches, and artificial teeth and limbs. The cost of a movable air conditioner may qualify if purchased for the use of a sick person.

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[28] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 134; S.Rep. 99-313, pp. 57-60; Senate floor amendment, 132 Cong. Rec. S 7665-73 (June 17, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 21-22 (Conference Report).

In addition, the regulations provide that the cost of a permanent improvement to property that ordinarily would not have a medical purpose (such as central air conditioning or an elevator) may be deductible as a medical expense if the expenditure is directly related to prescribed medical care, but only for any portion of the cost that exceeds the increased value of the property attributable to the improvement. Related operating and maintenance costs also may be deducted provided that the medical reason for the capital expenditure continues to exist.

Under these rules, the Internal Revenue Service has treated as medical expenses the cost of hand controls and other special equipment installed in a car to permit its use by a physically handicapped individual, including a mechanical device to lift the individual into the car (Rev. Rul. 66-80, 1966-1 C.B. 57). Also, the IRS has ruled that the additional costs of designing an automobile to accommodate wheelchair passengers constitute medical expenses, including the costs of adding ramps for entry and exit, rear doors that open wide, floor locks to hold the wheelchairs in place, and a raised roof giving the required headroom (Rev. Rul. 70-606, 1970-2 C.B. 66). Similarly, specialized equipment used with a telephone by an individual with a hearing disability has been held deductible as a medical expense, since the equipment was acquired primarily to mitigate the taxpayer's condition of deafness (Rev. Rul. 71-48, 1971-1 C.B. 99).

The IRS also has ruled that capital expenditures to accommodate a residence to a handicapped individual may be deductible as medical expenses (Rev. Rul. 70-395, 1970-2 C.B. 65). In that ruling, the taxpayer was handicapped with arthritis and a severe heart condition; as a result, he could not climb stairs or get into or out of a bathtub. On the advice of his doctor, he had bathroom plumbing fixtures, including a shower stall, installed on the first floor of a two-story house he rented. The lessor (an unrelated party) did not assume any of the costs of acquiring or installing the special plumbing fixtures and did not reduce the rent; the entire costs were paid by the taxpayer. The IRS concluded that the primary purpose of the acquisition and installment of the plumbing fixtures was for medical care, and hence that such expenses were deductible as medical expenses.

Reasons for Change

Floor under deduction

The Congress concluded that, as part of the approach of the Act in reducing tax rates through base-broadening, it was appropriate to increase the floor under the itemized deduction for medical expenses. A floor under this deduction has long been imposed in recognition that medical expenses essentially are personal expenses and thus, like food, clothing, and other expenditures of living and other consumption expenditures, generally should not be deductible in measuring taxable income.

In raising the deduction floor to 7.5 percent of the taxpayer's adjusted gross income, the Act retains the benefit of deductibility where an individual incurs extraordinary medical expenses—for example, as a result of major surgery, severe chronic disease, or catastrophic illness—that are not reimbursed through health insurance or Medicare. Thus, the Act continues deductibility if the unreimbursed expenses for a year are so great that they absorb a substantial portion of the taxpayer's income and hence substantially affect the taxpayer's ability to pay taxes. The Congress also believed that the higher floor, by reducing the number of returns claiming the deduction, will alleviate complexity associated with the deduction, including substantiation and audit verification problems and numerous definitional issues.

Capital expenditures

The Congress also concluded that it is desirable to clarify that certain capital expenditures incurred to accommodate a personal residence to the needs of a handicapped taxpayer, such as construction of entrance ramps or widening of doorways to allow use of wheelchairs, qualify as medical expenses eligible for the deduction. The Congress believed that this clarification was consistent with Federal policies that seek to enable handicapped individuals to live independently and productively in their homes and communities, thereby avoiding unnecessary institutionalization.

Explanation of Provision

Floor under deduction

The Act increases the floor under the itemized medical expense deduction from five to 7.5 percent of the taxpayer's adjusted gross income.

Capital expenditures

The Congress clarified that capital expenditures eligible for the medical expense deduction include certain expenses of removing structural barriers in the taxpayer's personal residence for the purpose of accommodating a physical handicap of the taxpayer (or the taxpayer's spouse or dependent). These costs are expenses paid by the taxpayer during the year, if not compensated for by insurance or otherwise, for (1) constructing entrance or exit ramps to the residence; (2) widening doorways at entrances or exits to the residence; (3) widening or otherwise modifying hallways and interior doorways to accommodate wheelchairs; (4) installing railings, support bars, or other modifications to bathrooms to accommodate handicapped individuals; (5) lowering of or other modifications to kitchen cabinets and equipment to accommodate access by handicapped individuals; and (6) adjustment of electrical outlets and fixtures. (The enumeration of these specific types of expenditures is not intended to preclude the Treasury Department from identifying in regulations or rulings similar expenditures for accommodating personal residences for physically handicapped individuals that would be eligible for deductibility as medical expenses.)

The Congress believed that the six categories of expenditures listed above do not add to the fair market value of a personal residence and hence intended that such expenditures are to count in full as eligible for the medical expense deduction in the year paid by the taxpayer.

Effective Date

The provision (increasing the deduction floor) is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $186 million in 1987, $1,223 million in 1988, $1,141 million in 1989, $1,276 million in 1990, and $1,427 million in 1991.

3. Repeal of deduction for certain adoption expenses (sec. 135 of the Act and sec. 222 of the Code) [29]

Prior Law

Prior law (sec. 222) provided an itemized deduction for up to $1,500 of expenses incurred by an individual in the legal adoption of a child with special needs. (This deduction became effective in 1981.) Deductible expenses included reasonable and necessary adoption fees, court costs, and attorney fees.

A child with special needs meant a child with respect to whom adoption assistance payments could be made under section 473 of the Social Security Act. In general, this meant a child who (1) the State had determined cannot or should not be returned to the home of the natural parents, and (2) could not reasonably be expected to be adopted unless adoption assistance was provided, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap).

Reasons for Change

The Congress believed that Federal benefits for families adopting children with special needs more appropriately should be provided through an expenditure program, rather than through an itemized deduction. The deduction provided relatively greater benefits to higher-income taxpayers, who presumably have relatively less need for Federal assistance, and no benefits to nonitemizers or to individuals whose income is so low that they had no tax liability. Also, the Congress believed that the agencies with responsibility and expertise in this area should have direct budgetary control over the assistance provided to families who adopt children with special needs.

Explanation of Provision

The Act repeals the prior-law itemized deduction for certain adoption expenses. Also, section 1711 of the Act amends the adoption assistance program in Title IV-E of the Social Security Act to provide matching funds as an administrative expense for adoption expenses for any child with special needs who has been placed for adoption in accordance with applicable State and local law (see explanation in Part XVII.D.5., below).

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[29] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 134; H. Rep. 99-426, p. 113; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 22-23 (Conference Report).

Effective Date

The provision repealing the prior-law itemized adoption expense deduction is effective for taxable years beginning on or after January 1, 1987.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1 million in 1987, $5 million in 1988, and $6 million annually in 1989-91.

4. Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel (sec. 144 of the Act and sec. 265(a) of the Code)[30]

Prior Law

Code section 265(a) disallows deductions for expenses allocable to tax-exempt income, such as expenses incurred in earning income on tax-exempt investments. In addition, that provision has been applied in certain cases where the use of tax-exempt income is sufficiently related to the generation of a deduction to warrant disallowance of that deduction.

Section 107 provides that gross income does not include (1) the rental value of a home furnished to a minister as part of compensation, or (2) the rental allowance paid to a minister as part of compensation, to the extent the allowance is used to rent or provide a home. In January 1983, the Internal Revenue Service ruled that prior-law section 265 precluded a minister from taking deductions for mortgage interest and real estate taxes on a residence to the extent that such expenditures are allocable to a tax-free housing allowance received by the minister (Rev. Rul. 83-3, 1983-1 C.B. 72). This ruling revoked a 1962 ruling which had taken a contrary position. In its 1983 ruling, the IRS stated that where a taxpayer incurs expenses for purposes for which tax-exempt income was received, permitting a full deduction for such expenses would lead to a double benefit not allowed under section 265 as interpreted by the courts.

The 1983 ruling generally was made applicable beginning July 1, 1983. However, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule was delayed by the IRS until January 1, 1985, with respect to such home (IRS Ann. 83-100). This transitional rule effective date was extended through 1985 by section 1052 of the Deficit Reduction Act of 1984 (P.L. 98-

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[30] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 144; H.Rep. 99-426, pp. 135-36; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 144; S.Rep. 99-313, pp. 60-61; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 23 (Conference Report).

369) and through 1986 by administrative action of the IRS (Rev. Rul. 85-96, 1985-29 I.R.B. 7).

In July 1985, the IRS announced that it had not "concluded its consideration of the question of whether members of the uniformed services are entitled, under current law, to take deductions on their income tax returns for home mortgage interest and property taxes to the extent they receive tax-free housing allowances from the Federal Government" (IRS Ann. 85-104). The IRS also stated that "any determination on the issue that would adversely affect members of the uniformed services will not be applied to home mortgage interest and property taxes paid before 1987."

For purposes of this rule, the IRS stated, the uniformed services include all branches of the armed forces, the National Oceanic and Atmospheric Administration, and the Public Health Service. Eligible members of such services, the IRS announcement stated, are entitled to receive tax-free housing and subsistence allowances if they do not reside on a Federal base (see Treas. Reg. sec. 1.61-2(b)).

Reasons for Change

The Congress concluded that it was appropriate to continue the long-standing tax treatment with respect to deductions for mortgage interest and real property taxes claimed by ministers and military personnel who receive tax-free housing allowances. In determining the level of regular military compensation, the Federal Government has assumed that such treatment would be continued.

Explanation of Provision

Under the Act, Code section 265 shall not disallow otherwise allowable deductions for interest paid on a mortgage on, or real property taxes paid on, the home of the taxpayer in the case of (1) a minister, on account of a parsonage allowance that is excludable from gross income under section 107, or (2) a member of a military service, on account of a subsistence, quarters, or other military housing allowance under Federal law (Code sec. 265(a)(6)). The term military service means the Army, Navy, Air Force, Marine Corps, Coast Guard, National Oceanic and Atmospheric Administration, and Public Health Service.

Effective Date

The provision applies for taxable years beginning before, on, or after December 31, 1986. The Act does not allow taxpayers to reopen any taxable years closed by the statute of limitations to claim refunds based on the provision.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

E. Expenses for Business or Investment

1. Limitations on deductions for meals, travel, and entertainment (sec. 142 of the Act and secs. 162, 170, 212, and 274 of the Code)[31]

Prior Law

Overview

In general, deductions are allowable for ordinary and necessary expenditures paid or incurred in carrying on a trade or business or for the production or collection of income (Code secs. 162, 212). Travel expenses incurred while away from home in the pursuit of a trade or business, including amounts expended for meals and lodging (other than amounts that are lavish or extravagant under the circumstances), generally qualify for the deduction (sec. 162(a)(2)).[32]

The taxpayer bears the burden of proving both the eligibility of an expenditure as a deduction and also the amount of any such eligible expenditure.[33] In addition, certain limitations and special substantiation requirements apply to travel and entertainment deductions (sec. 274). Taxpayers are subject to penalties if any part of an underpayment of tax (e.g., because of improperly claimed deductions) is due to negligence or intentional disregard of rules or regulations (sec. 6653(a)) or due to fraud (sec. 6653(b)).

No deduction is allowed for personal, family, or living expenses (sec. 262). For example, the costs of commuting to and from work are nondeductible personal expenses.[34] However, a special deduction is allowed for a limited amount of moving expenses (including certain travel and meal expenses) incurred by a taxpayer in connection with changing job locations or starting a new job, if certain requirements are met (sec. 217).

The Code provides that no deduction is allowed for a payment that is illegal under any Federal law or State law (but only if such State law is generally enforced) that subjects the payor to a criminal penalty or the loss of a license or privilege to engage in a trade or business. For example, if paying more than the face value for a ticket ("scalping") is illegal under an enforced State law, this rule disallows any otherwise available deduction of such payments as business entertainment expenses.

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[31] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 142; H.Rep. 99-426, pp. 115-130; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 142; S.Rep. 99-313, pp. 62-85; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 24-32 (Conference Report).

[32] See Part E.2., below, for rules relating to the deductibility of business expenses incurred by employees.

[33] See, e.g., *Interstate Transit Lines* v. *Comm'r*, 319 U.S. 590, 593 (1943); *Comm'r* v. *Heininger*, 320 U.S. 467 (19

[34] *Fausner* v. *Comm'r*, 413 U.S. 838 (1973).

Entertainment activities

In general

In general, expenditures relating to activities generally considered to constitute entertainment, amusement, or recreation are deductible only if the taxpayer establishes that (1) the item was directly related to the active conduct of the taxpayer's business or (2), in the case of an item directly preceding or following a substantial and bona fide business discussion, the item was associated with the active conduct of the taxpayer's business (sec. 274(a)). The "directly related" and "associated with" requirements are intended to require a more proximate relation between the entertainment expense and the taxpayer's business than would be required under the "ordinary and necessary" requirement applicable to all business expenses (including business entertainment expenses).

These special requirements apply (subject, under prior law, to ten statutory exceptions discussed in greater detail below) to entertainment expenses such as expenses incurred at nightclubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, and sporting events, and on hunting, fishing, or vacation trips or yachts, as well as to expenses of food or beverages, lodging not used for business purposes, or the personal use of employer-provided automobiles. If either statutory requirement is met or an exception applies, entertainment expenses of the taxpayer as well as entertainment expenses of the taxpayer's business guests (such as present or potential customers or clients, legal or business advisors, suppliers, etc.) are deductible, assuming all generally applicable requirements for business deductions are satisfied.

"Directly related" requirement

The Treasury regulations under section 274 provide several alternative tests for satisfying the "directly related" requirement. These tests generally are designed to require the taxpayer to show a clear business purpose for the expenditure and a reasonable expectation of business benefits to be derived from the expenditure. For example, under the "active business discussion" test, the taxpayer must have actively engaged in a business meeting during the entertainment period for the purpose of business benefit and must have had more than a general expectation of deriving some income or other business benefit (other than merely goodwill) at some indefinite future time.

The regulations presume that the "active business discussion" test is not met if the entertainment occurred under circumstances where there was little or no possibility of engaging in business. For example, the test is presumed not to have been met if there were substantial distractions, e.g., because the entertainment took place at a nightclub or a cocktail party, or if the taxpayer met with a group at a vacation resort that included nonbusiness-related individuals.

Even if the "active business discussion" test is not met, entertainment expenses are deemed "directly related" to business and hence satisfy the special section 274 limitation if incurred in a "clear business setting" directly in furtherance of the taxpayer's business. For example, the "clear business setting" test is met for expenses of entertainment taking place in a hospitality room at a convention, where business goodwill may be generated through the display of business products, or if civic leaders are entertained at the opening of a new hotel or theatrical production, provided that the clear purpose is to obtain business publicity. However, because of distracting circumstances, entertainment is presumed not to have occurred in a clear business setting in the case of a meeting or discussion taking place at a nightclub, theater, or sporting event, or during a cocktail party.

"Associated with" requirement

The second category of deductible entertainment expenditures under the regulations are expenses associated with the taxpayer's business that are incurred directly preceding or following a substantial and bona fide business discussion. This requirement generally permits the deduction of entertainment costs intended to encourage goodwill, provided that the taxpayer establishes a clear business purpose for the expenditure, assuming all generally applicable requirements for business deductions are satisfied.

The "associated with" requirement has not been viewed as requiring that business actually be transacted or discussed during the entertainment, that the discussion and entertainment take place on the same day, that the discussion last for any specified period, or that more time be devoted to business than to entertainment. Thus, if a taxpayer conducts negotiations with a group of business associates and that evening entertains them and their spouses at a restaurant, theater, concert, or sporting event, the entertainment expenses generally are considered deductible as "associated with" the active conduct of the taxpayer's business, even though the purpose of the entertainment is merely to promote goodwill. Entertainment taking place between business sessions or during evening hours at a convention is treated under the regulations as directly preceding or following a business discussion.

Entertainment facilities

The section 274 rules were amended by the Revenue Act of 1978 to disallow any deduction (or the investment tax credit) for the cost of entertainment facilities, subject to certain specific statutory exceptions. This general disallowance rule applies to property such as "skyboxes" in sports arenas, tennis courts, bowling alleys, yachts, swimming pools, hunting lodges, fishing camps, and vacation resorts.

Dues or fees paid to a social, athletic, or sporting club are deductible provided that more than half the taxpayer's use of the club is in furtherance of the taxpayer's trade or business and the item was directly related to the active conduct of such trade or business (sec. 274(a)(2)). The expenses of box seats and season tickets to theaters and sporting events have not been disallowed as expenses related to entertainment facilities. Instead, such costs were deductible under prior law if they met the requirements applied to entertainment activities and the general requirements for deducting business expenses.

Exceptions for certain entertainment activities

In general

Prior law included ten statutory exceptions to the general section 274 rules that an entertainment, recreation, or amusement activity expenditure must satisfy either the "directly related" or "associated with" requirement, and that entertainment facility costs are not deductible. If an exception applied, the entertainment expenditure was deductible if it constituted an ordinary and necessary business expense and if any applicable section 274(d) substantiation requirements were satisfied.

The prior-law exceptions were for (1) business meals (discussed below), (2) food and beverages furnished to employees on the taxpayer's business premises, (3) entertainment expenses treated by the employer and employee as compensation to the employee (and so reported on the employer's return and on Form W-2 furnished to the employee), (4) expenses paid by the taxpayer under a reimbursement or other expense allowance arrangement in connection with the performance of services, (5) expenses for recreational, social, or similar facilities or activities for the benefit of employees generally, (6) entertainment expenses directly related to bona fide meetings of a taxpayer's employees, stockholders, or directors, (7) entertainment expenses directly related to and necessary to attendance at a business meeting or convention of a tax-exempt trade association, (8) expenditures for entertainment (or a related facility) made available by the taxpayer to the general public, (9) expenses for entertainment sold by the taxpayer to the public, and (10) expenses includible in the income of persons who are not employees.

The regulations under section 274 provide that entertainment expenditures are not deductible to the extent they are lavish or extravagant. Under prior law, the Internal Revenue Service indicated that it would not interpret this provision to disallow deductions merely because entertainment expenses exceed a fixed dollar amount, are incurred at expensive restaurants, hotels, nightclubs, or resorts, or involve first-class accommodations or services (see Rev. Rul. 63-144, 1963-2 C.B. 129).

Meals

Under prior law, expenses for food and beverages were deductible, without regard to the "directly related" or "associated with" requirement generally applicable to entertainment expenses, if the meal or drinks took place in an atmosphere conducive to business discussion. There was no requirement under prior law that business actually be discussed before, during, or after the meal.

Travel expenses

Away from home travel

Traveling expenses incurred by the taxpayer while "away from home" in the conduct of a trade or business (e.g., where the taxpayer travels to another city for business reasons and stays there overnight) generally are deductible if the ordinary and necessary standard for business deductions is met (sec. 162(a)(2)). Personal living expenses such as food and lodging incurred during the trip may be deductible under this rule. However, travel deductions for amounts expended for meals and lodging are not allowable if such amounts are "lavish and extravagant under the circumstances" (sec. 162(a)(2)). In addition, deductions for any traveling expenses must be substantiated pursuant to section 274(d).

If, while away from home, a taxpayer engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible; however, any expenses while at the destination that are properly allocable to the taxpayer's trade or business are deductible. The determination of whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. An important factor in determining whether the trip is primarily personal is the amount of time during the period of the trip that is spent on personal activities compared to the amount of time spent on activities directly relating to the taxpayer's trade or business (Treas. Reg. sec. 1.162-2(b)).

Deductions for conventions held on cruise ships are limited to $2,000 per taxpayer per year, and are wholly disallowed unless the cruise ship is registered in the United States and stops only at ports of call in this country (including United States possessions) (sec. 274(b)(2)). Also, special rules apply in the case of travel outside the United States that lasts for more than one week (sec. 274(c)).

Traveling costs as deductible education expenses

Traveling expenses may be deductible as business expenses if the travel (1) maintains or improves existing employment skills or is required by the taxpayer's employer or by applicable rules or regulations, and (2) is directly related to the taxpayer's duties in his or her employment or trade or business. Under prior law, some individuals claimed deductions for travel expenses on the ground that the travel itself served educational purposes.

Traveling costs as deductible charitable contributions

A taxpayer may deduct, as charitable donations, unreimbursed out-of-pocket expenses incurred incident to the rendition of services provided by the taxpayer to a charitable organization (Treas. Reg. sec. 1.170A-1(g)). This rule applies to out-of-pocket transportation expenses, and reasonable expenditures for meals and lodging away from home, if necessarily incurred in performing donated services. (No charitable deduction is allowable for the value of the contributed services.) Under prior law, in some instances taxpayers claimed charitable deductions for travel expenses where the travel involved a significant element of personal pleasure, recreation, or vacation.

General substantiation requirements

As a general rule, deductions for travel, entertainment, and certain gift expenses are subject to stricter substantiation requirements than most other business deductions (sec. 274(d)). These stricter rules were enacted because the Congress recognized that "in many instances deductions are obtained by disguising personal expenses as business expenses." [34a]

Under the section 274 rules, the taxpayer must substantiate by adequate records, or sufficient evidence corroborating the taxpayer's statement, (1) the amount of the expense or item subject to section 274(d); (2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. These substantiation rules apply to: (1) traveling expenses (including meals and lodging while away from home); (2) expenditures with respect to entertainment, amusement, or recreation activities or facilities; and (3) business gifts. In addition, the Tax Reform Act of 1984 (P.L. 98-369) made additional property subject to the section 274(d) rules, including automobiles used for local travel; these additional categories of expense became subject to the section 274(d) substantiation requirements on January 1, 1986.

To meet the adequate records standard, documentary evidence (such as a receipt or paid bill) is required for any expenditure of $25 or more (except certain transportation charges). The Congress has emphasized that no deductions for expenditures subject to substantiation under section 274(d) are allowable pursuant to the *Cohan* approximation rule.[34b]

Reasons for Change

In general

Since the 1960's the Congress has sought to address various aspects of deductions for meals, entertainment, and travel expenses that the Congress and the public have viewed as unfairly benefiting those taxpayers who are able to take advantage of the tax benefit of deductibility. In his 1961 Tax Message, President Kennedy reported that "too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government." He stated: "This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well."

After careful review during consideration of the Act, the Congress concluded that these concerns were not addressed adequately by prior law. In general, prior law required some heightened showing of a business purpose for travel and entertainment costs, as well as stricter substantiation requirements than those applying generally to all business deductions; this approach is retained under the Act. However, the prior-law approach failed to address a basic issue inherent in allowing deductions for many travel and entertainment expenditures—the fact that, even if reported accurately and having some connection with the taxpayer's business, such expenditures also convey substantial personal benefits to the recipients.

[34a] H. Rpt. No. 87-1447, 87th Cong., 2d Sess. (1962), at 19.

[34b] *See, e.g.*, H. Rept. 99-67, 99th Cong., 1st Sess. 8-9 (1985) (Conference Report on P.L. 99-44).

The Congress believed that prior law, by not focusing sufficiently on the personal-consumption element of deductible meal and entertainment expenses, unfairly permitted taxpayers who could arrange business settings for personal consumption to receive, in effect, a Federal tax subsidy for such consumption that was not available to other taxpayers. The taxpayers who benefit from deductibility tend to have relatively high incomes, and in some cases the consumption may bear only a loose relationship to business necessity. For example, when executives have dinner at an expensive restaurant following business discussions and then deduct the cost of the meal, the fact that there may be some bona fide business connection does not alter the imbalance between the treatment of those persons, who have effectively transferred a portion of the cost of their meal to the Federal Government, and other individuals, who cannot deduct the cost of their meals.

The significance of this imbalance is heightened by the fact that business travel and entertainment often may be more lavish than comparable activities in a nonbusiness setting. For example, meals at expensive restaurants and the most desirable tickets at sports events and the theatre are purchased to a significant degree by taxpayers who claim business deductions for these expenses. This disparity is highly visible, and has contributed to public perceptions that the tax system under prior law was unfair. Polls indicated that the public identified the full deductibility of normal personal expenses such as meals and entertainment tickets to be one of the most significant elements of disrespect for and dissatisfaction with the tax system.

In light of these considerations, the Act generally reduces to 80 percent the amount of otherwise allowable deductions for business meals, including meals while on a business trip away from home, meals furnished on an employer's premises to its employees, and meal expense at a business luncheon club or a convention, and business entertainment expenses, including sports and theatre tickets and club dues. This reduction rule reflects the fact that all meals and entertainment inherently involve an element of personal living expenses, but still allows an 80-percent deduction where such expenses also have an identifiable business relationship. The Act also tightens the requirements for establishing a bona fide business reason for claiming food and beverage expenses as deductions. The Act includes specified exceptions to the general percentage reduction rule.

In certain respects, more liberal deduction rules were provided under prior law with respect to business meals than other entertainment expenses, both as to the underlying legal requirements for deductibility and as to substantiation requirements. The Congress concluded that more uniform deduction rules should apply; thus, deductions for meals are subject to the same business-connection requirement as applies for deducting other entertainment expenses.

Skybox rentals

Taxpayers generally cannot claim deductions or credits for the cost of entertainment facilities, including private luxury boxes ("skyboxes") at sports arenas. However, under prior law a taxpayer could circumvent this rule by leasing a skybox instead of purchasing it. Accordingly, the Act disallows deductions for all costs of leasing a skybox if the skybox is leased for more than one event during a taxable year; this disallowance rule is phased-in for taxable years beginning in 1987 and 1988.

Excess ticket costs

Under prior law, some taxpayers claimed entertainment expense deductions for ticket purchases in an amount that exceeded the face value of the tickets. For example, a taxpayer may pay an amount in excess of the face price to a "scalper" or ticket agent. The Congress concluded that deductions for ticket costs in excess of the face value amount generally should not be allowed. However, this limitation does not apply to ticket expenses for sports events meeting certain requirements under the Act relating to charitable fundraising.

Luxury water travel

The Congress concluded that prior law could allow excessive deductions for business travel undertaken by luxury water travel (e.g., by cruise ship). Taxpayers who engage in luxury water travel ostensibly for business purposes may have chosen this means of travel for personal enjoyment over other reasonable alternatives that may better serve business purposes by being faster and less expensive. Also, the costs of luxury water travel may include elements of entertainment and meals (not separately charged) that are not present in other transportation. Accordingly, the Act generally places per diem dollar limitations on deductions for luxury water transportation.

Travel as a form of education

The Congress was concerned about deductions claimed under prior law for travel as a form of education. The Congress concluded that any business purpose served by traveling for general educational purposes, in the absence of a specific need such as engaging in research which can only be performed at a particular facility, is at most indirect and insubstantial. By contrast, allowing deductions for travel as a form of education could provide substantial personal benefits by permitting some individuals in particular professions to deduct the cost of a vacation, while most individuals must pay for vacation trips out of after-tax dollars, no matter how educationally stimulating the travel may be. Accordingly, the Act disallows deductions for travel that can be claimed only on the ground that the travel itself is educational, but permits deductions for travel that is a necessary adjunct to engaging in an activity that gives rise to a business deduction relating to education.

Charitable deductions for travel expenses

The Congress also was concerned about charitable deductions claimed by some persons for expenses of travel away from home to visit places that customarily are visited as vacation sites or resorts. Prior to the Act, there had been a proliferation of widely publicized programs advertising that individuals could travel to appealing locations and claim charitable deductions for their travel and living costs, on the ground that the taxpayers were performing services assisting the charities. In many cases, however, the value of the services performed appeared to be minimal compared to the amount deducted, the amount of time spent during the day on activities benefiting the charitable organization was relatively small compared to the amount of time during the day available for recreation and sightseeing activities, or the activities performed were similar to activities that many individuals perform while on vacations paid for out of after-tax dollars.

Accordingly, the Congress concluded that charitable deductions for travel expenses away from home should be denied where the travel involves a significant element of personal pleasure, recreation, or vacation; this same rule applies for travel expenses claimed as medical deductions. However, deductions for such expenses as the out-of-pocket expenditures incurred by a troop leader on a youth group camping trip remain allowable.

Expenses for nonbusiness conventions

The Congress was concerned about deductions claimed under prior law for travel and other costs of attending conventions or other meetings that relate to financial or tax planning of investors, rather than to a trade or business of the taxpayer. For example, individuals claimed deductions for attending seminars about investments in securities or tax shelters. In many cases, these seminars were held in locations (including some that were overseas) that were attractive for vacation purposes, and were structured so as to permit extensive leisure activities on the part of attendees.

Since investment purposes do not relate to the taxpayer's means of earning a livelihood (which usually involves the conduct of a trade or business), the Congress concluded that these abuses, along with the personal consumption issue that arises with respect to any deduction for personal living expenses, justify denial of any deduction for the costs of attending a nonbusiness seminar or similar meeting that does not relate to a trade or business of the taxpayer. However, this disallowance rule does not apply to expenses incurred by a taxpayer in attending a convention, seminar, sales meeting, or similar meeting relating to the trade or business of the taxpayer that are deductible under section 162.

Explanation of Provisions

a. Percentage reduction for meal and entertainment expenses

In general

Under the Act, any amount otherwise allowable as a deduction under chapter 1 of the Code (secs. 1–1399) for any expenses for food or beverages, or for any item with respect to an entertainment, amusement, or recreation activity[35] or facility used in connection with such activity, is reduced by 20 percent (new Code sec. 274(n)).[36] Thus, if a taxpayer spends $100 for a business meal or an entertainment expense that, but for this rule, would be fully deductible, the amount of the allowable deduction is $80.

This reduction rule applies, for example, to food or beverage costs incurred in the course of travel away from home (whether eating alone or with others), in entertaining business customers at the taxpayer's place of business or a restaurant, or in attending a business convention or reception, business meeting, or business luncheon at a luncheon club. Similarly, the cost of a meal furnished by an employer to employees on the employer's premises is subject to the reduction rule, whether or not the value of the meal is excludable from the employee's gross income under section 119. As another example, meal expenses that are allowable (within certain limitations) as moving expenses deductible under section 217 are subject to the reduction rule. However, as discussed below, the Act provides certain exceptions to the percentage reduction rule.

In determining the amount of any otherwise allowable deduction that is subject to reduction under this rule, expenses for taxes and tips relating to a meal or entertainment activity are included. For example, in the case of a business meal for which the taxpayer pays $50, plus $4 in tax and $10 in tips, the amount of the deduction cannot exceed $51.20 (80 percent of $64). Expenses such as cover charges for admission to a night club, the amount paid for a room which the taxpayer rents for a dinner or cocktail party, or the amount paid for parking at a sports arena in order to attend an entertainment event there, likewise are deductible (if otherwise allowable) only to the extent of 80 percent under the rule. However, an otherwise allowable deduction for the cost of transportation to and from a business meal (e.g., cab fare to a restaurant) is not reduced pursuant to the rule.

The percentage reduction rule is applied only after determining the amount of the otherwise allowable deduction under section 162 (or section 212) and under other provisions of section 274. Meal and entertainment expenses first are limited to the extent (if any) required pursuant to other applicable rules set forth in sections 162, 212, or section 274, and then are reduced by 20 percent.[37]

For example, if a meal costs $100, but, under section 162(a)(2) or new section 274(k)(1), $40 of that amount is disallowed as lavish and extravagant, then the remaining $60 is reduced by 20 percent, leaving a deduction of $48. Similarly, when a taxpayer buys a ticket to an entertainment event for more than the ticket's face value, the deduction cannot exceed 80 percent of the face value of the ticket.

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[35] For purposes of this rule, an entertainment activity is defined in accordance with sec. 274(a)(1)(A), i.e., as an activity that is of a type generally considered to constitute entertainment, amusement, or recreation. Thus, for example, the percentage reduction rule applies to any amount of social or athletic club dues or fees that otherwise are allowable as business deductions under sec. 274(a)(2).

[36] If a tax-exempt organization incurs otherwise deductible meal or entertainment expenses in conducting an unrelated trade or business, the percentage reduction rule applies in computing the organization's unrelated business taxable income (secs. 511-514).

[37] However, if meal or entertainment costs incurred in the course of luxury water travel are separately stated, the percentage reduction rule is applied prior to application of the limitation on luxury water travel expenses in new sec. 274(m), as discussed below.

Following application of the percentage reduction rules as described above, the deductibility of an expense next is subject to the new two-percent floor under the total of unreimbursed employee business expenses and other miscellaneous itemized deductions (see Part I.E.2., below), if applicable to such expense, and then to any deduction limitation that is specifically expressed in dollars.[38] For example, assume that a self-employed individual incurs meal expenses that constitute moving expenses under section 217, subject to the dollar limitation (generally, $3,000) on deductibility of moving expenses contained in section 217(b)(3), or that an employee incurs such unreimbursed expenses. The taxpayer must first reduce the amount of such meal expenses by 20 percent; the dollar limitation in section 217(b)(3) then applies to the total of such meal expenses (as so reduced) and other types of allowable moving expenses. As discussed below, moving expenses are not subject to the new two-percent floor under miscellaneous itemized deductions.

The effect of the percentage reduction rule cannot be avoided by reason of the absence of separate charges for, payments for, or allocations as between meal and entertainment expenses subject to the rule, and business expenses that are deductible in full. For example, assume that a hotel charges $200 per night for a room, that it provides dinner and breakfast free of any separately stated charge, and that the amount properly allocable to the meals (or the right to the meals) is $50. Of the taxpayer's $200 payment to the hotel, assuming all other requirements for a business deduction are met, only $190 ($150 for the room, plus 80 percent of the $50 allocable to the meals)[39] is deductible. Similarly, if a business provides its employees with a fixed per diem amount to cover lodging and meal expenses incurred in business travel, an allocation on a reasonable basis must be made between the meal expenses and the lodging or other expenses, and the percentage reduction rule applies to the amount so allocated to meal expenses.

Exceptions to percentage reduction rule

The Act provides certain exceptions to the applicability of the percentage reduction rule.

First, the cost of a meal or of an entertainment activity is fully deductible if the full value thereof is treated as compensation to the recipient. Thus, if an employee is the recipient of meals or entertainment provided by his or her employer, the employer's expenses are not subject to the percentage reduction rule if the employer treats such expenses as compensation to the employee on the employer's tax return and as wages for income tax withholding purposes. Similarly, if the recipient is an independent contractor who has rendered services to the taxpayer, the taxpayer's expenses are not subject to the percentage reduction rule if the expenses are includible in the recipient's gross income as compensation (or as a prize or award under sec. 74) and the taxpayer includes such expenses on Form 1099 or other applicable information return issued to the recipient (unless the taxpayer is not required to do so because the aggregate amount paid to the recipient is less than $600).

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[38] Likewise, the percentage reduction rule applies prior to the deduction limitations on luxury water travel (in the case of separately stated meal and enteratinment expenses). See discussion below of the exception to the percentage reduction rule for qualified banquet meetings in 1987 and 1988.

[39] The Congress anticipated that the Treasury Department will provide additional guidance regarding when allocation is necessary and how the amounts properly allocable to meals and entertainment are to be determined.

Second, in the case of an employee who is reimbursed for expenses of a meal or of entertainment incurred in performing services for his or her employer, the percentage reduction rule does not apply to the reimbursed employee; instead, the percentage reduction rule applies to the employer making the reimbursement. This exception may apply, for example, in the case of a salesperson who pays for a lunch with a customer at which a sales contract is discussed and then is reimbursed under a reimbursement or other expense allowance arrangement with his or her employer; in that case, the person making the reimbursement can deduct only 80 percent of the reimbursement.[40] Similarly, a nonemployee service provider (such as an accounting firm) that provides the required substantiation (pursuant to sec. 274(d)) and is reimbursed by the service-recipient for meal and entertainment expenses incurred on the latter's behalf is not subject to the percentage reduction rule; instead, the service-recipient can deduct only 80 percent of the reimbursement.

Third, the percentage reduction rule does not apply in the case of certain traditional recreational expenses incurred by an employer primarily for the benefit of its employees (other than certain highly compensated, etc. employees). For example, this exception may apply in the case of an employer's deduction for meal and entertainment costs of a year-end holiday party or a summer picnic for all company employees and their spouses.

Fourth, the percentage reduction rule does not apply to an expense for food or beverages if the full value thereof is excludable from the recipient's gross income under Code section 132(e) as a de minimis fringe benefit. For example, a transfer for business purposes of a packaged food or beverage item (e.g., a holiday turkey or ham, fruitcake, or bottle of wine) is not subject to the percentage reduction rule if the section 132(e) de minimis fringe benefit exclusion applies. Similarly, the percentage-reduction rule does not apply to the cost of an employer-provided meal that is excludable from the employee's gross income as a de minimis fringe benefit under section 132(e)(2), relating to certain eating facilities where revenue derived from the facility normally equals or exceeds the direct operating costs of the facility and where access to the facility is available to employees on a nondiscriminatory basis. This exception does not apply to employer-provided meals that are excludable from the employee's gross income only pursuant to section 119, or to any entertainment expenses (whether or not excludable under sec. 132(e)).

Fifth, the reduction rule does not apply in the case of meal or entertainment expenses, such as samples and promotional activities, that are made available by the taxpayer to the general public.

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[40] The employer may deduct the full reimbursed amount if the employer treats such amount as compensation to the employee under the first exception described above.

For example, if the owner of a hardware store advertises that tickets to a sports event will be provided to the first 50 people who visit the store on a particular date, or who purchase an item from the store during a sale, then the full amount of the face value of the tickets is deductible by the owner. Similarly, a wine merchant who permits members of the public who are potential customers to sample wine of the type that the merchant is offering for sale may deduct in full the cost of wine used as a sample, along with reasonable costs that are associated with the winetasting (e.g., food that is provided with the wine to demonstrate the suitability of the wine for particular types of meals.)

Sixth, expenses for attendance at a sports event, to the extent otherwise allowable as a business deduction, are not subject to the percentage reduction rule if the event meets certain requirements related to charitable fundraising. In order for such costs to be subject to the percentage reduction rule under this exception, the event must (1) be organized for the primary purpose of benefiting a tax-exempt charitable organization (described in sec. 501(c)(3)), (2) contribute 100 percent of the net proceeds to the charity, and (3) use volunteers for substantially all work performed in carrying out the event. This rule applies to the cost of a ticket package, i.e., the amount paid both for seating at the event, and for related services such as parking, use of entertainment areas, contestant positions, and meals furnished at and as part of the event.

For example, a golf tournament that donates all of the net proceeds from the event to charity is eligible to qualify under this exception. Such a tournament would not fail to qualify solely because it offered prize money to golfers who participated, or used paid concessionaires or security personnel. However, it is intended that tickets to college or high school football or basketball games or other similar scholastic events will not qualify under the exception. Such games generally do not satisfy the requirement that substantially all work be performed by volunteers, if the institution (or parties acting on its behalf) pays individuals to perform such services as coaching or recruiting.

Seventh, the cost of providing meals or entertainment is fully deductible to the extent that it is sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. For example, a restaurant or dinner theater may deduct the full amount of its ordinary and necessary expenses in providing meals or entertainment to paying customers. Similarly, assume that an employer, not otherwise in the restaurant or catering business, provides meals on the premises to its employees for which the employer can establish that it charges arm's length, fair market value prices. Since in such circumstances the employees are paying adequate and full consideration, the value of the meals does not constitute compensation includible in gross income, even if the section 132(e) exclusion does not apply. For purposes of the above exception to the percentage reduction rule, the employer in these particular circumstances is treated, in effect, like a restaurant, and can deduct in full the cost of providing the meals.

However, a taxpayer cannot avoid the percentage reduction rule, where otherwise applicable, by reason of providing meals on the taxpayer's business premises. By way of illustration, assume that, in the above example, when an employee takes a customer of the employer to lunch on the premises, the employee's or the customer's meals, or both, are provided by the employer free of charge. Under these circumstances, only 80 percent of the cost of providing the free meals is deductible by the employer. If the employee actually paid for the cost of the meals and was not reimbursed by the employer, the percentage reduction rule would apply to the employee.

A restaurant or catering firm may deduct 100 percent (rather than 80 percent) of its costs for food and beverage items, purchased in connection with preparing and providing meals to its paying customers, that are consumed at work by employees of the restaurant or caterer. However, this rule applies only to employees who work in the employer's restaurant or catering business.

Eighth, expenses incurred in calendar year 1987 or calendar year 1988 for food or beverages that are provided as an integral part of a qualified banquet meeting are not subject to the percentage reduction rule if charges for the meal are not separately stated from other meeting expenses.[41] In the case of expenses incurred on or after January 1, 1989, the 80-percent reduction rule will apply to qualified banquet meeting meals in the same manner as to other business meals.

For purposes of this two-year exception, the term banquet meeting means a convention, seminar, annual meeting, or similar business program that includes the meal. The exception applies only if more than 50 percent of the participants at the banquet meeting are away from home (within the meaning of sec. 162(a)(2)), i.e., can deduct travel expenses under the "overnight" rule; (2) at least 40 persons attend the banquet meeting; and (3) the meal event is part of the banquet meeting and includes a speaker.[42] If a business program or other banquet meeting includes (for example) three meals, but there is a speaker only at one of the meals, only the one meal at which there is a speaker is eligible for the banquet meeting exception to the percentage reduction rule.

b. Additional requirements relating to meals

The Act also makes certain changes in the legal and substantiation requirements applicable to deductions for business meals; these changes apply independently of and prior to the percentage reduction rule (where applicable).

First, under the Act, deductions for meal expenses are subject to the same business-connection requirement as applied to deductions for other entertainment expenses under prior law (and continues to apply under present law).[43] Accordingly, an expense for food or beverages is not deductible unless (in addition to generally applicable deduction requirements) the taxpayer (1) establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the item was associated with the active conduct of the taxpayer's trade or business, and (2) substantiates the deduction as required by section 274(d) and Treas. Reg. sec. 1.274-5(b)(4).

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[41] Thus, this exception to the percentage reduction rule does not apply if a charge is made to persons consuming the meal for an amount for the meal separate from the charge for the program of which the meal is an integral part, or if program attendees who do not have the meal are refunded a separate amount for not having the meal. However, the exception does not become inapplicable merely because the hotel, caterer, or other business that is unrelated to the taxpayer and that provides the food or beverages may state to the taxpayer as program sponsor a separate amount that represents the food and beverage charges to the taxpayer, which amount the taxpayer then may factor into the total fee for the program that includes the meal.

[42] In order to qualify for this exception to the percentage reduction rule, it is not necessary that the speaker be paid an honorarium for speaking at the meal. This exception can apply to meals served at an employee training facility if the requirements (such as a bona fide speaker) for the exception are met.

Under this requirement, a business meal expense generally is not deductible unless there is a substantial and bona fide business discussion during, directly preceding, or directly following the meal. However, the absence of a business discussion does not preclude satisfying the "directly related" or "associated with" requirement in the case of an individual who is away from home in the pursuit of a trade or business and who has a meal alone or with persons, such as family members, who are not business-connected, and a deduction is claimed only for the meal of such individual, or in the case of a meal expense allowable as a moving expense.

For purposes of deducting food or beverage expenses, the business discussion requirement is deemed not to have been met if neither the taxpayer nor any employee of the taxpayer is present when the food or beverages are provided. Thus, for example, if the taxpayer reserves a table at a business dinner but neither the taxpayer nor an employee of the taxpayer attends the dinner, no deduction is allowed for the taxpayer's expenditures. Similarly, if one party to a contract negotiation buys dinner for other parties involved in the negotiations, but does not attend the dinner, the deduction is denied even if the other parties engage in a business discussion.[44]

For purposes of this rule, an independent contractor who renders significant services to the taxpayer (other than attending meals on the taxpayer's behalf, or providing services relating to meals) is treated as an employee, if he or she attends the meal in connection with such performance of services. Thus, for example, an attorney who was retained by a taxpayer to represent the taxpayer in a particular legal proceeding is to be treated as an employee of the taxpayer, for purposes of this rule, if the attorney represented the taxpayer at a business meal at which the legal proceeding was discussed.

The requirement for deductibility that the taxpayer must be present at the meal does not apply where an individual traveling away from home on business has a meal alone or with persons, such as family members, who are not business-connected, and a deduction is claimed only for the meal of such individual. Also, the taxpayer-presence requirement is subject to the same exceptions as apply under the Act to the percentage reduction rule.

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[43] Thus, the statutory exceptions to the business-connection requirement that apply in the case of other entertainment expenses also apply in the case of business meal expenses.

[44] However, the requirement that the taxpayer be present does not apply in the case of a transfer for business purposes of a packaged food or beverage item, such as a holiday turkey, ham, fruitcake, or bottle of wine.

Second, the Act explicitly provides, apart from the prior-law and present-law statutory rule (sec. 162(a)(2)) disallowing deductions for certain lavish and extravagant travel expenses (including meals), that no deduction is allowed for any food or beverage expense unless the expense is not lavish or extravagant under the circumstances (new sec. 274(k)(1)(A)). This additional provision reflects the intent of the Congress that this standard is to be enforced by the Internal Revenue Service and the courts.

This disallowance rule applies whether or not the expense is incurred while the taxpayer is away from home, and whether the taxpayer incurs the expense alone or with others. Since the percentage reduction is applied only after determining the otherwise allowable deduction under sections 162, 212, and 274, if a taxpayer incurs otherwise deductible business lunch expenses of (for example) $80 for himself and if $30 of that amount is not allowable as lavish or extravagant, the remaining $50 is then reduced by 20 percent, leaving a deduction of $40. This new disallowance rule (but not the sec. 162(a)(2) disallowance rule) is subject to the same exceptions as apply under the Act to the percentage reduction rule (e.g., where the full value of the food or beverages is treated as compensation to the recipient).

The rules of the Act reflect concerns of the Congress about deductions claimed under prior law for meals that did not clearly serve business purposes or were not adequately substantiated. Since the Act provides that deductions for meals are subject to the same business-connection requirement as applies under prior and present law for other entertainment expenses, the substantiation requirements for such entertainment expenses (e.g., in Treas. Reg. sec. 1.274-5(b)(4) with respect to the directly related or associated with requirement for deductibility) also apply to all meal expenses. In addition, the Treasury is instructed to adopt stricter substantiation requirements for business meals, except that the prior-law rule relating to certain expenditures of less than $25 is to be retained.

Under the Act, as under prior law, the Internal Revenue Service and the courts are not to apply the *Cohan* approximation rule to allow deductibility of any food or beverage expense, other entertainment expense, or other expenditure subject to substantiation pursuant to section 274(d) if the expenditure is not substantiated in accordance with section 274(d) and the regulations thereunder.

c. Deductions for tickets limited to face value

Under the Act, a deduction (if otherwise allowable) for the cost of a ticket for an entertainment activity is limited (prior to application of the percentage reduction rule) to the face value of the ticket. The face value of a ticket includes any amount of Federal, State, or local ticket tax on the ticket. Under this rule, a payment to a "scalper" for a ticket is not deductible (even if not disallowed as an illegal payment) to the extent that the amount paid exceeds the face value of the ticket. Similarly, a payment to a ticket agency or broker for a ticket is not deductible to the extent it exceeds the face value of the ticket.

However, the face value limitation does not apply to an expense that is excepted under the Act from the percentage reduction rule because it relates to a sports event that meets certain requirements related to charitable fundraising (see description above).

d. Disallowance of deductions for certain "skybox" rentals

The Act generally disallows any deductions relating to rental or similar payments for use of a "skybox" if the skybox is used by the taypayer (or related party) for more than one event during a taxable year. The term "skybox" means any private luxury box or other facility at a sports arena that is separated from other seating, and is available at a higher price (counting all applicable expenses, e.g., rental of the facility, as well as separate charges for food and seating) than the price generally applicable to other seating.

The disallowance rule applies if the taypayer (or a related party, including one engaged in a reciprocal rental arrangement with the taxpayer) rents a skybox at the same sports arena for more than one event. For purposes of this rule, a single game or other performance counts as one event. Thus, for example, a taxpayer who rents a skybox for two World Series games in the same stadium is treated as renting a skybox for two events. The deductibility of a single-event rental is determined under the rules generally applicable to entertainment activities, including the percentage reduction rule.

In determining whether a taypayer has rented a skybox for more than one event, all skybox rentals by the taypayer in the same arena, along with any related rentals, are considered together. For example, rentals of different skyboxes in the same stadium, or rentals by the same taxpayer pursuant to separate rental agreements, constitute related rentals. In addition, rentals by related parties are considered related rentals. For example, this rule applies where members of the same family, corporations or other entities with common ownership, or taxpayers who have made a reciprocal arrangement involving sharing skyboxes, respectively lease skyboxes for different events.

If the disallowance rule applies (i.e., if the taypayer rents a skybox for more than one event), the amount allowable as a deduction with respect to such events (including the first such rental) cannot exceed the face value of luxury box seat tickets generally held for sale to the public multiplied by the number of seats in the luxury box (subject, however, to further reduction under the percentage reduction rule). In addition, if expenses for food and beverages incurred by the taxpayer are separately stated, such expenses also may be deducted, subject to the rules generally applicable to business meal expenses, including the business-connection requirement, the prohibition on deducting lavish and extravagant expenses, the requirement of taxpayer presence, and the percentage reduction rule.

For example, in a stadium where box seats (other than in luxury boxes) are sold for between $8 and $12, a taypayer who rents a skybox for three events (and meets generally applicable deduction rules) may treat the deductible amount for the three events as equal to $12 multiplied by the number of seats in the luxury box, multiplied by three. This method applies whether or not the luxury box is occupied fully during the event, and without regard to whether amounts paid for the luxury box nominally constitute payments for the seats or rentals for the luxury box.

However, in determining the amount charged for nonluxury box seats, only prices charged for a genuine category of such seats are taken into account. Consider, for example, the case of a sports arena that, in order to increase the deductions allowable with respect to skyboxes, reserved a small group of seats for which it charged $50 even though those seats were not significantly better than the seats that it offered for $12. In such a case, the $50 price would be disregarded as not bona fide. Similarly, the skybox disallowance rule cannot be circumvented by charging inflated amounts for food and beverages provided in the skybox.

Under the Act, the skybox deduction disallowance rule is phased in. Under the phase-in provision, amounts disallowed for taxable years beginning in 1987 and 1988 are, respectively, one-third and two-thirds of the amounts that otherwise would be disallowed under the skybox provision if the provision were fully effective in those years. Assume, for example, that a calendar-year taxpayer rents a stadium skybox with 10 seats for eight events during 1987 at a total cost of $15,000 (with no additional separate charge for tickets), that the face value of a nonluxury box seat (determined as stated above) is $12, that all seats are occupied by business customers of the taypayer and the taypayer is present at each event, and that the total cost otherwise would be allowable as a business deduction. Under the Act as in effect following the phase-in, the taxpayer could deduct 80 percent of the face value ticket amounts (i.e., 80 percent of $960). For 1987, only one-third of the nonticket amount ($15,000 less $960) is disallowed, pursuant to the phase-in; i.e., $4,680 is disallowed. Thus, the taxpayer could deduct 80 percent of $9,360 ($14,040 less $4,680), or $7,488, plus 80 percent of the ticket amount, or $768. The total 1987 deduction for ticket and nonticket amounts would be $8,256.

For taxable years beginning after 1989, the Act generally disallows deductions for any costs of rental or other use of a skybox at a sports arena if the taxpayer (or a related party) uses the skybox for more than one event.

e. Travel as a form of education

Under the Act, no deduction is allowed for expenses for travel as a form of education. This rule applies when a travel deduction otherwise would be allowable only on the ground that the travel itself constitutes a form of education. Thus, for example, this provision disallows deductions for transportation or other travel expenses (including meals and lodging) incurred by a teacher of French who travels to and in France in order to maintain general familiarity with the French language and culture.

This disallowance rule does not apply to otherwise allowable deductions claimed with respect to travel that is a necessary adjunct to engaging in an activity that gives rise to a business deduction relating to education. For example, this disallowance rule does not apply where a scholar of French literature travels to Paris in order to do specific library research that cannot be done elsewhere, or to take courses that are offered only at the Sorbonne, in circumstances such that the nontravel research or course costs are deductible.

f. Charitable deductions for travel expenses

The Act places limitations on charitable deductions for the cost of travel away from home, effective for taxable years beginning after December 31, 1986.[45] Under this rule (sec. 170(k)), no charitable deduction is allowed for transportation and other travel expenses (including costs for meals and lodging) incurred in performing services away from home for a charitable organization unless there is no significant element of personal pleasure, recreation, or vacation in the travel away from home. The same limitation applies under prior and present law with respect to medical deductions for lodging costs away from home (sec. 213(d)(2)(B)).

This rule applies only with respect to expenses relating to travel by a taxpayer or by a person associated with the taxpayer (e.g., a family member). The rule does not apply to the extent that the taxpayer pays for travel by third parties who are participants in the charitable activity. For example, this disallowance rule does not apply to travel expenditures personally incurred by a troop leader for a tax-exempt youth group who takes children (unrelated to the taxpayer) belonging to the group on a camping trip. Similarly, the disallowance rule does not apply where an officer of a local branch of a national charitable organization travels to another city for the organization's annual meeting and spends the day attending meetings, even if the individual's evening is free for sightseeing or entertainment activities. However, the disallowance rule applies in the case of any reciprocal arrangement (e.g., when two unrelated taxpayers pay each other's travel expenses, or members of a group contribute to a fund that pays for all of their travel expenses).

The disallowance rule applies whether the travel expenses are paid directly by the taxpayer, or indirectly through reimbursement by the charitable organization. For this purpose, any arrangement whereby a taxpayer makes a payment to a charitable organization and the organization pays for his or her travel expenses is treated as a reimbursement.

In determining whether travel away from home involves a significant element of personal pleasure, recreation, or vacation, the fact that a taxpayer enjoys providing services to the charitable organization will not lead to denial of the deduction. For example, a troop leader for a tax-exempt youth group who takes children belonging to the group on a camping trip may qualify for a charitable deduction with respect to his or her own travel expenses if he or she is on duty in a genuine and substantial sense throughout the trip, even if he or she enjoys the trip or enjoys supervising children. By contrast, a taxpayer who only has nominal duties relating to the performance of services for the charity, who for significant portions of the trip is not required to render services, or who performs activities similar to activities that many individuals perform while on vacations paid out of after-tax dollars, is not allowed any charitable deduction for travel costs.

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[45] A taxpayer cannot circumvent this effective date by "setting aside" amounts, or paying amounts, prior to January 1, 1987, to a fund or account that is to be used to finance travel costs after December 31, 1986 that would be nondeductible expenditures under the Act.

The disallowance rule in the Act has no effect on deductions other than charitable deductions that may be claimed with respect to travel on behalf of a charitable organization. For example, the rule does not affect the eligibility for deduction under section 162 of an employee business expense incurred by an employee of a charitable organization.

g. Expenses for nonbusiness conventions, etc.

Under the Act, no deduction is allowed for expenses related to attending a convention, seminar, or similar meeting unless such expenses qualify under section 162 as ordinary and necessary expenses of carrying on a trade or business of the taxpayer. Thus, the Act disallows deductions for expenses of attending a convention, etc. where the expenses, but for the provision in the Act, would be deductible under section 212 (relating to expenses of producing income) rather than section 162.

The disallowed expenses to which the provision relates typically include such items as travel to the site of such a convention, registration or other fees for attending the convention, and personal living expenses, such as meals, lodging, and local travel, that are incurred while attending the convention or other meeting. This disallowance rule does not apply to expenses incurred by a taxpayer in attending a convention, seminar, sales meeting, or similar meeting relating to the trade or business of the taxpayer that are deductible under section 162.

In adopting this provision, the Congress also was concerned that some taxpayers may be claiming deductions under section 162 for travel and other costs of attending a convention, seminar, or similar meeting ("convention") at which each convention participant is furnished individually with video tapes of lectures, etc. on topics related to the taxpayer's trade or business, to be viewed at the convenience of the participant, and at which no other significant business-related activities occur during the time allotted for the convention. In such situations, the taxpayer does not participate in activities normally conducted at a business-related convention, such as participating in meetings, discussions, workshops, lectures, or exhibits held during the day, and simply views the tapes at his or her own convenience. Because permitting deductions for travel, meal, or entertainment costs associated with such minimal business-related activities would allow taxpayers to treat expenditures that essentially are for vacation, recreation, or other personal purpose as business expenses, the Congress clarified that no deduction is allowable under section 162 for travel or related costs (such as meals, lodging, or local transportation) of attending such a convention.

This clarification does not disallow deductions for the travel and other costs of attending a convention that involves activities otherwise deductible under present law which are related to the taxpayer's trade or business merely because the convention utilizes video-taped or televised materials where the participants must attend a convention session in person to view the video-taped materials, assuming that the generally applicable requirements for deducting expenses of attending a convention are satisfied.[46] Under those requirements, traveling expenses to and from the convention destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, deductions are allowable only for expenses (if any) incurred while at the destination that are properly allocable to the taxpayer's trade or business.

The determination of whether a trip is related primarily to the taxpayer's trade or business, rather than being primarily personal in nature, depends on the facts and circumstances in each case. An important factor in determining whether the trip is primarily personal is the amount of time during the period of the trip that is spent on personal activities compared to the amount of time spent on activities directly relating to the taxpayer's trade or business (Treas. Reg. sec. 1.162-2(b)).

By way of illustration, assume that a four-day convention is held at a resort or vacation location, that the convention sessions (whether or not utilizing video-taped materials) are scheduled solely for two hours each evening, and that the taxpayer does not engage in any nonconvention business activities during the day. In such a case, a taxpayer could not deduct any away-from-home expenses (travel, lodging, or meals) incurred on his or her trip because the travel is not related primarily to the taxpayer's trade or business, but could deduct any expenses properly allocable to the convention sessions, subject to the rule described above relating to furnished video-taped materials.

h. Luxury water travel

The Act places limitations on the amount of any otherwise allowable deduction for costs of travel by ocean liner, cruise ship, or other form of luxury water transportation. This rule applies, for example, in the case of a taxpayer who has business reasons for traveling from New York City to London and who travels by ocean liner.

Under the Act, the deduction allowable in the case of luxury water travel cannot exceed twice the highest amount generally allowable with respect to a day of travel to employees of the executive branch of the Federal Government while away from home but serving in the United States, multiplied by the number of days the taxpayer was engaged in luxury water travel. For example, if during a particular taxable year the highest applicable Federal per diem amount is $126 for travel in the United States, a taxpayer's deduction for a six-day trip cannot exceed $1,512 ($252 per day times six days). The applicable per diem amount generally is the highest travel amount applying for an area in the conterminous United States; however, any limited special exception to this amount (e.g., a higher limit that applied only to high-ranking executive personnel) would be disregarded.

If the portion of the expenses of luxury water travel that are for meals or entertainment are separately stated, the amounts so separately stated are reduced by 20 percent, under the percentage reduction rule, prior to application of this per diem limitation. However, in the absence of separately stated meal or entertainment charges, taxpayers are not required to allocate a portion of the total amount charged for luxury water travel to meals or entertainment unless the amounts to be allocated are clearly identifiable. This special rule, applicable only in the case of luxury water travel, applies in light of the fact that the Act imposes a flat dollar limitation on deductibility of all travel—for transportation, lodging, and meals—incurred in luxury water transportation.

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[46] Also, this clarification does not disallow deductions for costs, other than travel, meal, or entertainment expenses, of renting or using business-related video-taped materials that are deductible trade or business expenses under section 162.

The per diem limitation for luxury water travel does not apply in the case of any expense allocable to a convention, seminar, or other meeting that is held on any cruise ship. Thus, the per diem limitation does not alter the application of the rule (sec. 274(h)(2)) under which deductions for conventions held aboard cruise ships are wholly denied or, in certain special cases, allowed to the extent not in excess of $2,000 per individual. Under the Act, the statutory exceptions to the business meal percentage reduction rule (described above) are also exceptions to the per diem rule with respect to luxury water travel.

Effective Date

The provisions are effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $1,180 million in 1987, $2,068 million in 1988, $2,397 million in 1989 $2,787 million in 1990, and $3,070 million in 1991.

2. Floor on deductibility of miscellaneous itemized deductions; modifications to certain employee business expense deductions (sec. 132 of the Act and sec. 62 and new sec. 67 of the Code)[47]

Prior Law

In general

The list of itemized deductions on Schedule A of Form 1040 includes a category labeled miscellaneous deductions, following the listings for medical expenses, charitable donations, interest, taxes, and casualty and theft losses. Under prior law, this category generally included four types of deductions: (1) certain employee business expenses (sec. 162); (2) expenses of producing income (sec. 212); (3) expenses related to filing tax returns (sec. 212); and (4) expenses of adopting children with special needs (sec. 222).

Employee business expenses

An employee business expense is a cost incurred by an employee in the course of performing his or her job. Examples of such costs include an employee's expenditures for subscriptions to professional journals or continuing education courses, union or professional dues, costs of professional uniforms, costs of looking for new employment, and expenses allowable for business use of the employee's home. Ordinary and necessary employee business expenses generally are deductible.

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[47] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 132; H. Rep. 99-426, pp. 108-111; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 132-33; S. Rep. 99-313, pp. 77-80; and H. Rep. 99-841, Vol. II (September 18, 1986) pp. 32-34 (Conference Report).

Employee business expenses generally can be claimed only as itemized deductions. However, under prior law four types of employee business expenses were deductible above-the-line in calculating adjusted gross income, and thus were directly available to nonitemizers: (1) certain expenses paid by an employee and reimbursed under an arrangement with the employer; (2) employee travel expenses incurred while away from home; (3) employee transportation expenses incurred while on business; and (4) business expenses of employees who are outside salespersons (sec. 62(2)).[48] In addition, the section 217 moving expense deduction was allowable above-the-line to employees or self-employed individuals.

Certain deductions for employee business expenses also are subject to specific limitations or restrictions. For example, a taxpayer's business use of his or her home (whether or not the taxpayer is in the business of being an employee) does not give rise to a deduction for the business portion of expenses related to operating the home (e.g., depreciation and repairs) unless the taxpayer uses a part of the home regularly and exclusively as the principal place of business or as a place of business used by patients, clients, or customers (sec. 280A).[49] Educational expenses are deductible only if the education (1) is required by the employer, by law, or by regulations, or (2) maintains or improves skills required to perform the taxpayer's present occupation.[50] Costs of looking for new employment are deductible only if they relate to employment in the taxpayer's present occupation. Also, special substantiation requirements must be met in order to deduct certain employee expenses, such as traveling expenses (sec. 274(d)).

Investment expenses

In general, expenses of producing income other than rental or royalty income are treated as itemized deductions if the related activity does not constitute a trade or business. (Trade or business expenses and expenses of producing rental or royalty income are deductible above-the-line.) Among the types of investment expenses that may be eligible, in particular circumstances, for deduction are investment counsel and trust administration fees, subscriptions to investment advisory publications, and attorneys' fees incurred in collecting income.

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[48] For this purpose, the term outside salesperson meant an individual who solicits business as a full-time salesperson for his or her employer away from the employer's place of business. The term outside salesperson did not include a taxpayer whose principal activities consist of service and delivery, such as a bread driver-salesperson. However, an outside salesperson could perform incidental inside activities at the employer's place of business, such as writing up and transmitting orders and spending short periods at the employer's place of business to make and receive telephone calls (Treas. Reg. sec. 1.62-1(h)).

[49] See secs. 143(b) and 143(c) of the Act, amending the rules relating to home office deductions.

[50] See sec. 142 of the Act, disallowing deductions for travel as a form of education.

Other miscellaneous itemized deductions

Tax counsel and assistance fees, as well as appraisal fees paid to determine the amount of a casualty loss or a charitable contribution of property, may be claimed as itemized deductions (sec. 212(3)).

Expenses incurred with respect to a hobby—i.e., an activity that may generate some gross income but that the taxpayer conducts for personal recreational reasons, rather than with the goal of earning a profit—are deductible as itemized deductions to the extent such expenses would be deductible regardless of profit motivation (e.g., certain interest and taxes) or to the extent of income from the hobby.[51] Gambling losses are deductible as itemized deductions to the extent of gambling gains.

Reasons for Change

The Congress concluded that the prior-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fostered significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures. For taxpayers who anticipated claiming such itemized deductions, prior law effectively required extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service. These problems were exacerbated by the fact that taxpayers frequently made errors of law regarding what types of expenditures were properly allowable under prior law as miscellaneous itemized deductions.[52]

Since many taxpayers incur some expenses that are allowable as miscellaneous itemized deductions, but these expenses commonly are small in amount, the Congress concluded that the complexity created by prior law was undesirable. At the same time, the Congress concluded that taxpayers with unusually large employee business or investment expenses should be permitted an itemized deduction reflecting that fact. Similarly, in the case of medical expenses and casualty losses, a floor is provided (under prior and present law) to limit those deductions to unusual expenditures that may significantly affect the individual's disposable income.

Accordingly, the Congress concluded that the imposition of a two-percent floor on miscellaneous itemized deductions constituted a desirable simplification of the tax law. This floor will relieve taxpayers of the burden of recordkeeping unless they expect to incur expenditures in excess of the floor. Also, the percentage floor will relieve the Internal Revenue Service of the burden of auditing deductions for such expenditures when not significant in aggregate amount.

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[51] See sec. 143(a) of the Act, amending the rules relating to hobby losses.

[52] Common taxpayer errors have included disregarding the restrictions on home office deductions, and on the types of education expenses that are deductible; claiming a deduction for safe deposit expenses even if used only to store personal belongings; and deducting the cost of subscriptions to widely read publications outlining business information without a sufficient business or investment purpose.

The use of a deduction floor also takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer. For example, membership dues paid to professional associations may serve both business purposes and also have voluntary and personal aspects; similarly, subscriptions to publications may help taxpayers in conducting a profession and also may convey personal and recreational benefits. Taxpayers presumably would rent safe deposit boxes to hold personal belongings such as jewelry even if the cost, to the extent related to investment assets such as stock certificates, were not deductible.

The Congress also concluded that the distinction under prior law between employee business expenses (other than reimbursements) that were allowable above-the-line, and such expenses that were allowable only as itemized deductions, was not supportable in most instances. The reason for allowing these expenses as deductions (i.e., the fact that they may constitute costs of earning income) and the reasons for imposing a percentage floor apply equally to both types of expenses. However, the Congress concluded that it would not be appropriate to apply the new percentage floor to the moving expense deduction (which is subject to separate dollar limitations under sec. 217) or to the new deduction for certain impairment-related work expenses of handicapped individuals (which applies only in limited circumstances).

Explanation of Provisions

Under the Act, all employee business expenses, other than reimbursed expenses described in section 62(a)(2)(A) and the new deduction for certain performing artists, are allowed only as itemized deductions. Thus, under the Act, unreimbursed employee travel expenses incurred away from home, employee transportation expenses incurred while on business, business expenses of employees who are outside salespersons, and employee moving expenses no longer are deductible above-the-line in calculating adjusted gross income. Also, the section 217 moving expense deduction is allowable to a self-employed individual only as an itemized deduction.

The Act also provides that, subject to certain exceptions, the total of all the taxpayer's miscellaneous itemized deductions, including employee business expenses that are not deductible above-the-line, are subject under the Act to a floor of two percent of the taxpayer's adjusted gross income. Thus, for example, if an itemizer with AGI of $30,000 incurs miscellaneous itemized deductions totaling $757, the allowable amount of such deductions is $157.

However, the two-percent floor does not apply to the following miscellaneous itemized deductions, if otherwise allowable: impairment-related work expenses for handicapped employees (new Code sec. 67(d)); [53] moving expenses (sec. 217); the estate tax in the case of income in respect to a decedent (sec. 691(c)); certain adjustments where a taxpayer restores amounts held under a claim of right

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[53] The term "impairment-related work expenses" means expenses of a handicapped individual (as defined in sec. 190(b)(3)) for attendant care services at the individual's place of employment that are necessary for such individual to be able to work, provided such expenses are otherwise deductible under sec. 162.

(sec. 1341); amortizable bond premium (sec. 171); certain costs of cooperative housing corporations (sec. 216); deductions allowable in connection with personal property used in a short sale; certain terminated annuity payments (new Code sec. 72(b)(3)); and gambling losses to the extent of gambling winnings (sec. 165(d)). In addition, it is intended that the two-percent floor is not applicable to deductions allowable to estates or trusts under sections 642(c), 651, and 661.[54]

The Act did not modify the above-the-line deduction under section 62(a)(2)(A) for certain reimbursed expenses (allowable under secs. 161-196 of the Code) paid or incurred by the taxpayer, in connection with performing services as an employee, under a reimbursement or other expense allowance arrangement with his or her employer. Thus, the Act did not alter the prior-law rules[55] relating to an employee who incurs expenses solely for the benefit of the employer and who is reimbursed for those expenses under an arrangement with the employer (regardless of whether the employer or a third party for whom the employee performs a benefit as an employee of the employer actually provides the reimbursement).[56] These rules provide that such an employee need not report on the employee's tax return either the expenses or the reimbursement (to the extent the reimbursement does not exceed the expenses). The Congress intended that this nonreporting rule is to be continued.

If the employee has a reimbursement or other expense allowance arrangement with his or her employer, but under the arrangement the full amount of such expenses is not reimbursed, the unreimbursed portion paid by the employee is allowable only to the extent (if any) otherwise allowable as an itemized deduction (e.g., after taking into account the percentage reduction rule for meals and entertainment expenses, if applicable to the expense), and subject to the two-percent floor provided by the Act.[57]

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[54] A technical correction may be necessary so that the statute reflects this intent. Such a correction was included in the version of H. Con. Res. 395 that passed the Senate in the 99th Congress.

[55] See Treas. Reg. secs. 1.162-17(b), 1.274-5T(f), and 1.274-5(e). For rules relating to reporting and substantiation of certain reimbursements of persons other than employees, see Reg. secs. 1.274-5T(h) and 1.274-5(g).

[56] The Congress intended that the Treasury make explicit in these regulations that these reimbursements by third parties are to be treated as expenses described in sec. 62(a)(2)(A).

[57] Under the Act, it is intended that the Treasury Department issue regulations or other guidance coordinating the treatment of employee business expenses and the provisions in sec. 162(h), relating to travel expenses away from home of State legislators. Under the intended rules, any excess of the allowable amount as determined under sec. 162(h) over the amount actually reimbursed to the legislator electing that provision would be allocated between meals and other travel expenses in accordance with the ratio of meals and other travel expenses under the Federal per diem reimbursement rules for travel in the United States. The reimbursed amount would be deductible pursuant to sec. 62(a)(2)(A), and 80 percent of the amount allocated to meals would be deductible by itemizers as an employee business expense (subject to the new two-percent floor under miscellaneous itemized deductions).

As described in the text above, the two-percent floor applies after application of the percentage reduction rule and prior to any deduction limitation that is specifically expressed in dollars. For example, with regard to away-from-home expenses of Members of Congress, the two-percent floor applies prior to application of the statutory $3,000 limitation (sec. 162(a)). In addition, if a Member has expenses subject to the $3,000 limitation and other miscellaneous itemized deductions, the amounts disallowed by the two-percent floor are disallowed proportionately. For example, assume that a Member with adjusted gross income of $100,000 has $5,000 of away-from-home expenses (qualifying for the deduction, disregarding application of the $3,000 limit and the two-percent floor, but after application of the 80-percent rule for meal and entertainment expenses) and $5,000 of other miscellaneous itemized deductions, for a total of $10,000 of potential deductions subject to the two-percent floor. Application of the two-percent floor would limit

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Pursuant to Treasury regulations, the two-percent floor is to apply with respect to indirect deductions through pass-through entities (including mutual funds) other than estates, nongrantor trusts, cooperatives, and REITs (sec. 67(c)). The floor also applies with respect to indirect deductions through grantor trusts, partnerships, and S corporations by virtue of grantor trust and pass-through rules.

In the case of an estate or trust, the Act provides that adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are not subject to the floor. The regulations to be prescribed by the Treasury Department relating to application of the floor with respect to indirect deductions through certain pass-through entitles are to include such reporting requirements as may be necessary to effectuate this provision.

Under the Act, an actor or other individual who performs services in the performing arts (a "performing artist") is allowed a new above-the-line deduction for his or her employee business expenses (allowable under sec. 162) during a year if the performing artist for that year (1) had more than one employer (excluding any nominal employer)[58] in the performing arts, (2) incurred allowable section 162 expenses as an employee in connection with such services in the performing arts in an amount exceeding 10 percent of the individual's gross income from such services, and (3) did not have adjusted gross income, as determined before deducting such expenses, exceeding $16,000. In general, if the performing artist is married at the close of the taxable year, this deduction is available only if the taxpayer and his or her spouse file a joint return for the year, and only if the combined adjusted gross income of the taxpayer and his or her spouse (as determined before deducting such expenses) shown on the return does not exceed $16,000. (Code sec. 62(b)).

Effective Date

The provisions apply to taxable years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $694 million in 1987, $4,630 million in 1988, $4,716 million in 1989, $5,039 million in 1990, and $5,383 million in 1991.

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these deductions to $8,000, and the amount disallowed because of the two-percent floor would be disallowed proportionately. Thus, after application of the two-percent floor, the Member could deduct $4,000 of the away-from-home expenses and $4,000 of the miscellaneous itemized deductions. The former amount (i.e., the away-from-home expenses) is further limited to $3,000 because of the special limitation on deducting Member's expenses. Thus, the Member could deduct a total of $7,000 of miscellaneous itemized deductions. See 132 Cong. Rec. H8357 (daily ed. Sept. 25, 1986) (statement of Mr. Rostenkowski).

[58] The Code provides that an employer is treated as nominal if the amount received by the individual for his or her services as an employee in the performing arts for such employer during the taxable year is less than $200.

3. Changes in treatment of hobby losses (sec. 143(a) of the Act and sec. 183 of the Code)[59]

Prior Law

Expenses arising from hobbies (i.e., activities not engaged in for profit) are allowed only as itemized deductions. Except for expenses that are deductible without reference to whether they are incurred in an activity designed to produce income (e.g., certain residential mortgage interest and real property taxes), hobby expenses are deductible only to the extent not exceeding the amount of hobby income for the year (Code sec. 183). These rules apply, for example, to activities such as horse breeding, farming, and researching a restaurant or travel guide, if the taxpayer's motivations are recreational rather than profit-oriented.

A facts and circumstances test generally applies to determine whether a particular activity constitutes a hobby. However, statutory rules provided under prior law that if the gross income from an activity exceeded the deductions attributable thereto for two or more out of five consecutive years (seven consecutive years in the case of an activity which consisted in major part of the breeding, training, showing, or racing of horses), then the activity was presumed to be engaged in for profit rather than as a hobby. The presumption that an activity was not a hobby if it was profitable in two out of five consecutive years (or seven consecutive years, for certain horse activities) could be overcome by the Internal Revenue Service under the general facts and circumstances test.

Reasons for Change

The Congress was concerned that the statutory presumption under prior law regarding whether an activity was being engaged in for profit may have unduly benefited some taxpayers who engaged in activities as hobbies, but who could structure their earnings and expenses so as to realize a profit in at least two out of five consecutive years. For example, the prior-law presumption could apply even if the taxpayer realized a substantial net loss over five years that reflected a willingness to incur losses as the cost of personal recreation, rather than unexpected business difficulties. Even though the Internal Revenue Service could overcome the statutory presumption, some abuse nonetheless could arise, in light of the subjective nature of a general facts and circumstances test. However, in the case of horse breeding, training, showing, and racing activities, the Congress concluded that the prior-law rules should continue to apply.

Explanation of Provision

Under the Act, for activities other than those consisting in major part of horse breeding, training, showing, or racing, the statutory presumption of being engaged in for profit applies only if the activity is profitable in three out of five consecutive years. As under prior law, this presumption can be overcome by the Internal Revenue Service under the general facts and circumstances test.

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[59] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 143; H.Rep. 99-426; pp. 130-32; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 143(a); S. Rep. 99-313, pp. 80-81; and H. Rep. 99-841, Vol. II (September 18, 1986) pp. 35-36 (Conference Report).

As in the case of other expenses that under prior and present law are deductible as miscellaneous itemized deductions, deductions for hobby expenses—other than costs that are deductible without reference to whether they are incurred in an activity designed to produce income (such as certain taxes)—are subject to the two-percent floor under section 132 of the Act.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision relating to the statutory presumption is estimated to increase fiscal year budget receipts by a negligible amount.

4. Changes in restrictions on deductions for business use of home (secs. 143(b) and (c) of the Act and sec. 280A of the Code)[60]

Prior Law

In general

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., depreciation and repairs). However, deductions are allowed only with respect to a part of the home that is used exclusively and regularly either as the principal place of business for a trade or business of the taxpayer or as a place of business used to meet or deal with patients, clients, or customers in the normal course of the taxpayer's trade or business, or if the part of the home used for business purposes constitutes a separate structure not attached to the dwelling unit (Code sec. 280A). In the case of an employee, a further requirement for a deduction is that the business use of the home must be for the convenience of the employer (sec. 280A(c)(1)).

For an employee, any deductions for depreciation or operating expenses of a home allowable under these rules generally must be claimed as itemized deductions. If an employee receives employer reimbursements for home office costs and includes the reimbursements in gross income, the home office expenses generally are reported on Form 2106 and are deductible "above-the-line" as an adjustment to gross income; under prior law, an employee who constituted an "outside" salesperson similarly deducted such amounts above-the-line. Self-employed individuals claim any allowable deductions for home office expenses above-the-line on Schedule C of Form 1040.

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[60] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 143(c); H. Rep. 99-426, pp. 132-35; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 143; S. Rep. 99-313, pp. 81-85; and H. Rep. 99-841, Vol. II (September 18, 1986) p. 35 (Conference Report).

Rental use of home

The general business-use requirements described above do not apply in the case of rental use of a part of the home (e.g., when the taxpayer rents a room to a lodger). In a recent Tax Court case interpreting prior law (*Feldman* v. *Comm'r*, 84 T.C. 1 (1985), *aff'd*, 791 F.2d 781 (9th Cir. 1986)), this rental exception was applied, and the general requirements for the deduction held inapplicable, where an employer nominally rented a portion of the employee's home used by the employee in performing services for the employer. The court permitted the taxpayer to deduct home office expenses without requiring regular and exclusive use of the home either as the taxpayer's principal place of business or as a place to meet or deal with patients, clients, or customers, notwithstanding the court's finding that the rental was not an arm's length arrangement and was made for more than the fair rental value of the space that nominally was rented.

Limitations on deduction

Deductions for home office costs that are allowed solely because there is a qualifying business use of the home are limited to the amount of the taxpayer's gross income derived from the business use of the home during the taxable year. Costs in excess of the limitation cannot be carried over and used as deductions in other taxable years. This limitation has no effect on deductions (such as certain home mortgage interest and real property taxes) that are allowable in the absence of business use.

The Internal Revenue Service has issued proposed regulations defining gross income derived from the business use of the home as gross income from the business activity in the unit reduced by expenditures required for the activity but not allocable to the use of the unit itself, such as expenditures for supplies and compensation paid to other persons.[61] However, in *Scott* v. *Comm'r*, 84 T.C. 683 (1985), the Tax Court rejected this interpretation of prior law, holding that gross income from the use of the home means gross income from the business activity itself, i.e., not reduced by any outside expenditures required for the activity.

Under the Tax Court's interpretation, deductions for business use of one's home could be used to create or increase a net loss from the activity and thus, in effect, to offset income from unrelated activities. For example, assume that a taxpayer derived gross income of $1,000 from an activity, and incurred expenses of $1,500 that related to the activity but that did not relate to use of the home (e.g., expenses for supplies, secretaries, and messengers). Under the Tax Court's interpretation of prior law, the taxpayer would be permitted to deduct up to $1,000 in home office costs that are not otherwise deductible (e.g., rent or depreciation), despite the fact that there was no net income from the activity.

Reasons for Change

The provision of the Act placing a two-percent floor under miscellaneous itemized deductions (see Part I.E.2., above) partially alleviates concerns of the Congress about the rules governing home office deductions claimed by employees. However, to the extent home office expenses remain deductible by self-employed persons or to some extent by employees, the Congress concluded that the following modifications to the deductibility of such expenses are desirable.

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[61] Proposed Treas. Reg. sec. 1.280A-2(i)(2)(iii), 48 Fed. Reg. 33325 (July 21, 1983).

Requirements for deduction

The Congress concluded that taxpayers should not be able to circumvent the limitations on home office deductions by arranging for their employers to rent portions of their homes. The allowance of such arrangements would significantly narrow the applicability of section 280A and could encourage tax avoidance of the sort that section was intended to prevent.

Section 280A was enacted because of concerns that some taxpayers were converting nondeductible personal and living expenses into deductible business expenses simply because they found it convenient to perform some work at home.[62] The Congress recognized that in some instances a legitimate cost resulting from business use of a home could conceivably be disallowed under the restrictions of section 280A; however, any such instances would be difficult to identify and define.

Further, the Congress believed that allowing deductions for use of a taxpayer's residence inherently involves the potential for abuse. In enacting section 280A, the Congress had concluded that absent limitations, taxpayers could claim home office deductions even when no marginal cost of maintaining the home was incurred by the taxpayer as a result of the business use. Thus, the Congress had concluded that home office deductions should be disallowed in the absence of specified circumstances indicating a compelling reason for business use of the home, and in any event should not be permitted to offset taxable income derived from unrelated activities.

Under the interpretation of prior-law section 280A applied by the Tax Court in the *Feldman* decision, the Congress concluded the statute would fail to achieve its intended purpose. Allowing employees to use lease arrangements with employers as a method of circumventing the restrictions on home office deductions might encourage some taxpayers to arrange sham transactions whereby a portion of salary is paid in the form of rent. Moreover, it is questionable whether lease transactions between an employer and employee are generally negotiated at arm's length, particularly if such a transaction could provide added tax deductions to the employee at no additional cost to the employer. Accordingly, the Congress concluded that no home office deductions should be allowable (except for expenses such as certain home mortgage interest and real property taxes that are deductible absent business use) if the employee rents a portion of his or her home to the employer.

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[62] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), at 139.

Limitations on deduction

In general.—The *Scott* decision would permit taxpayers to use home office deductions to create or increase a net loss from the business activity, and thus to offset unrelated income. The Congress believed that a home office deduction to which section 280A applies should not be used to reduce taxable income from the activity to less than zero. In adopting the provisions of the Act, the Congress reemphasized that section 280A was enacted because of concerns about allowing deductions for items which have a substantial personal component relating to the home, which most taxpayers cannot deduct, and which frequently do not reflect the incurring of significantly increased costs as a result of the business activity, and that the provision should be interpreted to carry out its objectives.

Carryover.—The Congress concluded that the application of section 280A under prior law might be unduly harsh in one respect. Deductions that are disallowed because they exceed the statutory limitation (i.e., the amount of income from the business activity) cannot be carried forward to subsequent taxable years and claimed to the extent of subsequent income from the home office activity. However, since the purpose of this limitation is to deny the use of home office deductions to offset unrelated income, the Congress concluded that deduction carryforwards should be allowed, subject to the general limitation that the home office deductions in any year cannot create or increase a net loss from the business activity.

Explanation of Provisions

Requirements for deduction

The Act provides that no home office deduction is allowable by reason of business use where an employee leases a portion of his or her home to the employer.[63] For this purpose, an individual who is an independent contractor is treated as an employee, and the party for whom such individual is performing services is treated as an employer. In the case of a lease that is subject to this rule, no home office deductions are allowed except to the extent that they would be allowable in the absence of any business use (e.g., certain home mortgage interest expense and real property taxes).

Limitations on deduction

In general.—The Act limits the amount of a home office deduction (other than expenses that are deductible without regard to business use, such as certain home mortgage interest expense and real property taxes) to the taxpayer's gross income from the activity, reduced by all other deductible expenses attributable to the activity but not allocable to the use of the unit itself. Thus, home office deductions are not allowed to the extent that they create or increase a net loss from the business activity to which they relate.

Carryover.—The Act provides a carryforward for those home office deductions that are disallowed solely due to the income limitation on the amount of an otherwise allowable home office deduction. Deductions that meet the general requirements of section 280A but that are disallowed solely because of the income limitation may be carried forward to subsequent taxable years, subject to the continuing application of the income limitation to prevent the use of such deductions to create or increase a net loss in any year from the business activity.

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[63] Also, payments to an employee from his or her employer that constitute wages are not exempted from withholding requirements and employment taxes merely because the employer and employee label such payments as "rent" under a "rental" or "lease" agreement.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

F. Repeal of Political Contributions Tax Credit (Sec. 112 of the Act and sec. 24 of the Code)[64]

Prior Law

Individual taxpayers could claim a nonrefundable income tax credit equal to one-half the amount of their contributions during the year to political candidates and certain political campaign organizations (Code sec. 24). The maximum allowable credit was $50 for an individual and $100 for a married couple filing a joint return.

Reasons for Change

The Congress concluded that, as part of the approach of the Act to reduce tax rates through base-broadening, it was appropriate to repeal the political contributions tax credit. The Congress also understood that data compiled by the Internal Revenue Service suggest that a significant percentage of persons claiming the credit have sufficiently high incomes to make contributions in after-tax dollars, without the benefit of the credit. Also, the credit provided no incentive for individuals with no income tax liability for the year. The small credit amount allowable per return under the dollar limitations made verification costly in relation to the tax liability at issue.

Explanation of Provision

The Act repeals the credit for political contributions.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $327 million in 1988, $341 million in 1989, $354 million in 1990, and $368 million in 1991.

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[64] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 112; H. Rep. 99-426, pp. 95-96; House floor amendment, 131 Cong. Rec. H 12731 (Dec. 17, 1985); H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 112; S. Rep. 99-313, p. 86; and H. Rep. 99-841, Vol. II (September 18, 1986) p. 37 (Conference Report).

TITLE II—CAPITAL COST PROVISIONS

A. Depreciation; Regular Investment Tax Credit; and Finance Leases (Secs. 201, 202, 203, 204, 211, 212, and 213 of the Act and secs. 38, 46, 57, 168, 178, 179, 280F, 312(k), 467, 1245, 1250, and new sec. 49 of the Code)[1]

Prior Law

Accelerated depreciation

Overview

The Economic Recovery Tax Act of 1981 ("ERTA") enacted the Accelerated Cost Recovery System ("ACRS") for tangible depreciable property placed in service after 1980. Under ACRS, the cost or other basis of eligible property (without reduction for salvage value) was recovered using an accelerated method of depreciation over a predetermined recovery period. Before ACRS was enacted, an asset's cost (less salvage value) was recovered over its estimated useful life. The pre-ACRS rules remain in effect for property placed in service by a taxpayer before 1981, and for property not eligible for ACRS.

Under ACRS, the allowable recovery deduction in each taxable year was determined by applying a statutory percentage to the property's original cost (adjusted, as described below, for investment tax credit allowed).

Personal property

The statutory percentages for personal property were based on the 150-percent declining balance method for the early recovery years, switching to the straight-line method at a time to maximize the recovery allowance. Alternatively, taxpayers could elect to use the straight-line method over the applicable ACRS recovery period (or over a longer recovery period) with respect to one or more classes of ACRS property placed in service during a taxable year (sec. 168(b)(3)(A)). Under a "half-year" convention, the statutory tables and straight-line alternatives provided a half-year recovery allowance for the first recovery year, whether the property was placed in service early or late in the year. No recovery allowance was allowed in the taxable year in which a taxpayer disposed of an asset.

The cost of eligible personal property was recovered over a three-year, five-year, 10-year, or 15-year recovery period, depending on the recovery class of the property.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 201-211; H.Rep. 99-426, pp. 137-190; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 201-213; S.Rep. 99-313, pp. 87-117; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 38-66 (Conference Report).

The classification of personal property under ACRS generally was based on the Asset Depreciation Range ("ADR") system of the law in effect before 1981. Under the ADR system, a present class life ("midpoint") was provided for all assets used in the same activity, other than certain assets with common characteristics (*e.g.*, automobiles). Property with an ADR midpoint life of four years or less (such as automobiles, light general purpose trucks, certain special tools, and over-the-road tractor units), racehorses more than two years old when placed in service, other horses more than 12 years old when placed in service, and property used in connection with research and experimentation were included in the three-year class. The 10-year class included long-lived public utility property with an ADR midpoint life from 18.5 to 25 years, certain burners and boilers, and railroad tank cars. Longer-lived public utility property having an ADR midpoint life over 25 years was in the 15-year class. Personal property not included in any other class was assigned to the five-year class.

Taxpayers were required to reduce the basis of assets by 50 percent of the amount of regular or energy investment tax credits allowed with respect to personal property (and the reduced basis was used to compute recovery deductions). With respect to the regular investment tax credit, a taxpayer could elect a 2-percentage point reduction in the credit in lieu of the half-basis adjustment.

Real property

The statutory percentages for real property were based on the 175-percent declining balance method (200-percent for low-income housing described in prior law section 1250(a)(1)(B)(i)-(iv)), switching to the straight-line method at a time to maximize the deduction. For the year of acquisition and disposition of real property, the recovery allowances were based on the number of months during those years that the property was in service. Under a "mid-month" convention, real property (other than low-income housing) placed in service or disposed of by a taxpayer at any time during a month was treated as having been placed in service or disposed of in the middle of the month.

For real property placed in service after May 8, 1985, the cost was recovered over a 19-year recovery period (15 years for low-income housing), although longer recovery periods could be elected.

Generally, low-income housing included projects eligible for various Federal, State, and local housing programs and projects where 85 percent of the tenants are eligible for, but do not necessarily receive, subsidies under Section 8 of the Housing Act of 1937.

Component cost recovery was not permitted under ACRS. Thus, the same recovery period and method had to be used for a building as a whole, including all structural components. A substantial improvement (generally, one that is made over a two-year period at a cost that is at least 25 percent of a building's unadjusted basis) was treated as a separate building, the cost of which was separately recovered when the improvement was placed in service.

If the 15-percent or 20-percent investment tax credit for rehabilitation expenditures was allowed, the basis of real property was reduced by the amount of credit earned (and the reduced basis was used to compute recovery deductions). The basis of real property was reduced by 50 percent of the 25-percent credit allowed for the rehabilitation of a certified historic structure. In addition, if a credit for rehabilitation expenditures was allowed, the straight-line method of cost recovery had to be used with respect to the rehabilitation expenditures.

Recapture

With certain limited exceptions, gain from the disposition of depreciable property was "recaptured" as ordinary income to the extent of previously allowed ACRS deductions (sec. 1245). For residential real property that was held for more than one year, gain was treated as ordinary income only to the extent the depreciation deductions allowed under the prescribed accelerated method exceeded the deductions that would have been allowed under the straight-line method (prior law sec. 1250(b)(1)). In addition, recapture for qualified low-income housing was phased out after such property had been held for a prescribed number of months, at the rate of one percentage point per month (prior law sec. 1250(a)(1)(B)). For nonresidential real property held for more than one year, there was no recapture if the taxpayer elected to recover the property's cost using the straight-line method over the applicable ACRS recovery periods (prior law sec. 1245(a)(5)(C)). If accelerated depreciation was claimed with respect to nonresidential real property, the full amount of the depreciation deductions previously taken (to the extent of gain) was recaptured.

Application of different depreciation methods for certain purposes

In general, ACRS recovery allowances were reduced for property that is (1) used predominantly outside the United States ("foreign-use property"), (2) leased to a tax-exempt entity, including a foreign person—unless more than 50 percent of the gross income derived from the property was subject to U.S. tax—("tax-exempt use property"), or (3) financed with industrial development bonds the interest on which is exempt from taxation.

Different depreciation methods were also used for purposes of computing earnings and profits of a domestic corporation and applying the minimum tax provisions.

Foreign-use property

The rationale for reducing ACRS deductions for foreign-use property is that the investment incentive is intended to encourage capital investment in the United States and should not be available to property used predominantly outside the United States.

The recovery period for foreign-use personal property was equal to the asset's ADR midpoint life (12 years for property without a midpoint life), and the 200-percent declining balance method could be used. The recovery period for foreign-use real property was 35 years, and the 150-percent declining balance method could be used. A taxpayer could elect to use the straight-line method over the applicable recovery period or certain longer periods.

Communications satellites, as defined in section 48(a)(2)(B), were excluded from the definition of foreign-use property. Other spacecraft (and interests therein) were not specifically excluded from the definition of foreign-use property.

Tax-exempt use property

The policy underlying the restriction on tax-exempt use property is to provide tax-reducing incentives only to those who are subject to income tax, and to deny them to tax-exempt entities, including foreign entities.

Depreciation deductions for tax-exempt use property were computed using the straight-line method and disregarding salvage value. The cost of tax-exempt use personal property was generally recovered over the longer of the asset's ADR midpoint life (12 years if the property had no ADR midpoint life) or 125 percent of the lease term. The recovery period for qualified technological property subject to these rules was five years. The recovery period for tax-exempt use real property was the longer of 40 years or 125 percent of the lease term. A taxpayer could elect to recover the cost of tax-exempt use property over an optional extended recovery period. The rules for tax-exempt use property overrode the rules relating to foreign-use property.

Property financed with industrial development bonds

Except in the case of property placed in service in connection with projects for residential rental property, the cost of property that was financed with tax-exempt industrial development bonds was recovered using the straight-line method over either the applicable ACRS recovery period or an optional extended recovery period.

Computation of earnings and profits

If an accelerated depreciation method were used for purposes of computing earnings and profits, the acceleration of depreciation deductions would reduce a corporation's earnings and profits, and thereby facilitate the distribution of tax-free dividends. For this reason, domestic corporations were required to compute earnings and profits using the straight-line method over recovery periods that were longer than the standard ACRS recovery periods.

The extended recovery periods used to compute earnings and profits were: (1) five years for three-year property, (2) 12 years for five-year property, (3) 25 years for 10-year property, (4) 35 years for 15-year public utility property, and (5) 40 years for 19-year real property and low-income housing.

Minimum taxes

The minimum tax provisions are designed to prevent taxpayers with substantial economic income from avoiding tax liability by using certain exclusions, deductions, and credits (referred to as "items of tax preference"). In applicable cases, the excess of ACRS deductions over depreciation deductions that would have been allowed had the taxpayer used the straight-line method over a prescribed recovery period were treated as items of tax preference. For purposes of this rule, the prescribed recovery periods were: (1) five years for three-year property, (2) eight years for five-year property, (3) 15 years for 10-year property, (4) 22 years for 15-year public utility property, (5) 15 years for low-income housing, and (6) 19 years for real property other than low-income housing. These rules applied to personal property subject to a lease and 19-year real property and low-income housing (prior law sec. 57(a)(12)). Further, personal property subject to a lease was not taken into account for corporations other than personal holding companies (as defined in sec. 542).

Luxury automobiles and mixed-use property

ACRS deductions were subject to fixed limitations for automobiles and reduced for certain property (including automobiles) used for both personal and business purposes (prior law sec. 280F). For luxury automobiles, depreciation deductions were limited to $3,200 for the first year in the recovery period, and $4,800 for each succeeding year. For mixed-use property used 50 percent or more for personal purposes, capital costs—to the extent of business use—were recovered using the straight-line method of depreciation over the same recovery periods that were used for purposes of computing the earnings and profits of a domestic corporation. ACRS was available for mixed-use property used more than 50 percent for business purposes, but only with respect to the portion of the property's basis attributable to business use.

Mass asset vintage accounts

In general, taxpayers computed depreciation deductions, as well as gain or loss on disposition, on an asset-by-asset basis. A taxpayer could elect to establish mass asset vintage accounts for assets in the same recovery class and placed in service in the same taxable year. Under proposed Treasury regulations, the definition of mass assets eligible for this treatment was limited to assets (1) each of which is minor in value relative to the total value of such assets, (2) that are numerous in quantity, (3) that are usually accounted for only on a total dollar or quantity basis, and (4) with respect to which separate identification is impractical (Prop. Treas. reg. sec. 1.168-2(h)(2)).

Lessee-leasehold improvements

In general, if a lessee made improvements to property, the lessee was entitled to recover the cost of the improvement over the shorter of the ACRS recovery period applicable to the property or the portion of the term of the lease remaining on the date the property was acquired. If the remaining lease term was shorter than the recovery period, the cost was amortized over the remaining term of the lease. For purposes of these rules, under prior law section 178, if the remaining term of a lease was less than 60 percent of the improvement's ACRS recovery period, the term of a lease was treated as including any period for which the lease could be renewed pursuant to an option exercisable by the lessee, unless the lessee established that it was more probable that the lease would not be renewed. In any case, a renewal period had to be taken into account if there was a reasonable certainty the lease would be renewed. Section 178 also provided rules relating to the amortization of lease acquisition costs.

Public utility property

In general

In general, a regulatory commission allows a public utility to charge customers rates that are sufficient to recover the utility's cost of service. A public utility's cost of service includes its annual operating expense and the capital expense allocable to a year. The capital expense that can be passed through to customers consists of an annual depreciation charge for equipment and also a rate of return on the capital invested in the equipment and other property (which capital is referred to as the "rate base").

ACRS distinguished between long-lived public utility equipment and other equipment. Further, as described below, public utilities were required to use a "normalization" method of accounting for ACRS deductions.

Definition of public utility property.—In general, public utility property was defined as property used predominantly in the trade or business of furnishing or selling:

(1) electrical energy, water, or sewage disposal services,

(2) gas or steam through a local distribution system,

(3) telephone services,

(4) other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.C.C. sec. 701), or

(5) transportation of gas or steam by pipeline,

if the rates are established or approved by certain regulatory bodies.

Normalization accounting

A public utility could use ACRS only if a "normalization" method of accounting was used for purposes of establishing the utility's cost of service and reflecting operating results in its regulated books of account. Normalization required that (1) a utility's tax expense for ratemaking purposes be computed as if the depreciation deduction were computed in the same manner as the ratemaking allowance for depreciation (which is generally based on the straight-line method over relatively long useful lives), (2) the deferred taxes (i.e., the difference between the actual tax expense computed using ACRS and that computed for ratemaking purposes) be reflected in a reserve (and thus be available for capital investment), and (3) the regulatory commission not exclude from the rate base an amount that is greater than the amount of the reserve for the period used in determining the tax expense as part of the utility's cost of service (*see* Treas. reg. sec. 1.167(l)-1, which interprets a similar provision of pre-ACRS law).

Normalization prevented the immediate lowering of rates charged to customers as a result of the cost savings from ACRS. Rather, current tax reductions were flowed through to customers over the period of tax deferral.

Expensing of up to $5,000 of personal property

A taxpayer (other than a trust or estate) could elect to deduct the cost of up to $5,000 of qualifying personal property in the year the property was placed in service, in lieu of recovering the cost under ACRS (prior law sec. 179). In general, qualifying property had to be acquired by purchase for use in a trade or business, and eligible for the investment tax credit (although no investment credit was allowed for the portion of the cost expensed under this rule). The $5,000 limit was scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for years beginning after 1989.

If expensed property was converted to nonbusiness use within two years of the time the property was placed in service, the difference between the amount expensed and the ACRS deductions that would have been allowed for the period of business use was recaptured as ordinary income.

Anti-churning rules

Under rules enacted as part of ACRS, taxpayers were prevented from bringing property placed in service before January 1, 1981 under ACRS by certain post effective date transactions (referred to as "churning transactions"). In general, churning transactions include those in which either the owner or user of property before January 1, 1981 (or a related party) is the owner or user immediately after the transaction. Taxpayers subject to the anti-churning rules compute depreciation under the law in effect before 1981.

Regular investment tax credit

General rule

A credit against income tax liability was allowed for up to 10 percent of a taxpayer's investment in certain tangible depreciable property (generally, not including buildings or their structural components) (secs. 38 and 46). The amount of the regular investment credit was based on the ACRS recovery class to which the property was assigned. The 10-percent credit was allowed for eligible property in the five-year, 10-year, or 15-year public utility property class. Three-year ACRS property was eligible for a six-percent regular credit (even if the taxpayer elected to use a longer recovery period). The maximum amount of a taxpayer's investment in used property that was eligible for the regular investment credit was $125,000 per year; the limitation on used property was scheduled to increase to $150,000 for taxable years beginning after 1987.

Generally, the investment credit was claimed for the taxable year in which qualifying property was placed in service. In cases where property was constructed over a period of two or more years, an election was provided under which the credit could be claimed on the basis of qualified progress expenditures ("QPEs") made during the period of construction before the property was completed and placed in service. Investment credits claimed on QPEs were subject to recapture if the property failed to qualify for the investment credit when placed in service.

The amount of income tax liability that could be reduced by investment tax credits in any year was limited to $25,000 plus 85 percent of the liability in excess of $25,000 (sec. 38(c)). Unused credits for a taxable year could be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following taxable years (sec. 39).

Public utility property

Public utility property was eligible for the regular investment credit only if the tax benefits of the credit were normalized in setting rates charged by the utility to customers and in reflecting operating results in regulated books of account (sec. 46(f)). The investment credit was denied for public utility property if the regulatory commission's treatment of the credit resulted in benefits being flowed through to customers more rapidly than under either (1) the ratable flow-through method or (2) the rate base reduction method.

Under the ratable flow-through method (sec. 46(f)(2)), utilities passed through to customers a pro rata portion of the credit during each year of the useful life of the asset. The regulatory commission could not require that the utility reduce its rate base by the amount of the credit. Therefore, even though the credit itself was flowed through to customers over the life of the asset, the utility's shareholders were allowed to earn a return on that amount of the cost of the equipment which had, in effect, been supplied by the Federal government through the regular investment credit.

Under the rate base reduction method (sec. 46(f)(1)), the utility's rate base was reduced by the amount of the credit, so the shareholders were prevented from earning a return on that part of the cost of the equipment which was paid for by the credit. Under this method, the regulatory commission could not require that the utility flow through to customers any part of the credit itself, or allow the utility to charge customers for the depreciation expense on the entire cost of the equipment, including the part paid for by the investment credit.

Finance leases

Overview

The law contains rules to determine who owns an item of property for tax purposes when the property is subject to an agreement that the parties characterize as a lease. Such rules are important because the owner of the property is entitled to claim tax benefits including cost recovery deductions and investment tax credits with respect to the property. These rules attempt to distinguish between true leases, in which the lessor owns the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owns the property for tax purposes. These rules generally are not written in the Internal Revenue Code. Instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law is that the economic substance of a transaction, not its form, determines who is the owner of property for tax purposes. Thus, if a transaction is, in substance, simply a financing arrangement, it is treated that way for tax purposes, regardless of how the parties choose to characterize it. Under these rules, lease transactions cannot be used solely for the purpose of transferring tax benefits; they have to have nontax economic substance.

Finance lease provisions

The Tax Equity and Fiscal Responsibility Act of 1982 provided rules (finance lease rules) that liberalized the leasing rules with respect to certain property. Under the finance leasing rules, the fact that (1) the lessee had an option to purchase the property at a fixed price of 10 percent or more of its original cost to the lessor, or (2) the property could be used only by the lessee (referred to as "limited use property"), could not be taken into account in determining whether the agreement was a lease.

A qualified agreement under the finance lease rules had to be a lease determined without taking into account the fact that it contained a 10-percent fixed price purchase option or that the property was limited use property. Thus, the transaction had to have economic substance independent of tax benefits. The lessor had to reasonably expect to derive a profit independent of tax benefits. In addition, the transaction, without taking into account the fact the agreement contains a fixed price purchase option or that the property is limited use property, could not otherwise be considered a financing arrangement or conditional sale.

The finance lease rules were to have been generally effective for agreements entered into after December 31, 1983, with three temporary restrictions intended to limit the tax benefits of finance leasing in 1984 and 1985. First, no more than 40 percent of property placed in service by a lessee during any calendar year beginning before 1986 was to qualify for finance lease treatment. Second, a lessor could not have used finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. This 50-percent lessor cap was to apply to property placed in service on or before September 30, 1985. Third, the investment tax credit for property subject to a finance lease and placed in service on or before September 30, 1985, was only allowable ratably over 5 years, rather than entirely in the year the property was placed in service.

Notwithstanding these general rules, finance leasing was to be available for up to $150,000 per calendar year of a lessee's farm property for agreements entered into after July 1, 1982, and before 1984. Furthermore, the 40-percent lessee cap, 50-percent lessor cap, and 5-year spread of the investment credit did not apply to this amount of farm property.

The Tax Reform Act of 1984, however, postponed the effective date of the finance lease rules to generally apply to agreements entered into after December 31, 1987, and extended the three restrictions. Thus, the 40-percent lessee cap was extended to property placed in service by a lessee during any calendar year beginning before 1990; the 50-percent lessor cap was extended through September 30, 1989; and the 5-year spread of the investment credit for property subject to a finance lease was extended to property placed in service on or before September 30, 1989.

The Tax Reform Act of 1984 provided transitional rules which exempted property from the 4-year postponement if, before March 7, 1984, (1) a binding contract to acquire or construct the property was entered into by or for the lessee, (2) the property was acquired by the lessee, or (3) construction of the property was begun by or for the lessee. In addition, the Act exempted from the 4-year postponement property that is placed in service before 1988 and is (1) a qualified lessee's automotive manufacturing property (limited to an aggregate of $150 million of cost basis per lessee) or (2) property that was part of a coal-fired cogeneration facility for which certification and construction permit applications were filed on specified dates. The special rules relating to the availability of finance leasing for up to $150,000 per calendar year of a lessee's farm property were extended to cover agreements entered into before 1988.

Reasons for Change

ACRS provides a small number of depreciation classes and relatively short recovery periods. The Congress chose to maintain this structure, while adopting improvements. For example, the Congress believed ACRS could be made more neutral by increasing the recovery period for certain long-lived equipment, and by extending the recovery period of real property. Another modification approved by the Congress provides equal recovery periods for the long-lived assets of regulated and nonregulated utilities. Under prior law, nonregulated utilities received more favorable depreciation treatment, which may have resulted in an unfair competitive advantage where they provided essentially the same services as regulated utilities.

The Congress concluded that some further acceleration in the rate of recovery of depreciation deductions should be provided to compensate partly for the repeal of the investment tax credit. The Act increases the rate of acceleration from 150-percent declining balance to 200-percent declining balance for property in the 3-year, 5-year, 7-year, and 10-year classes. Together with the large tax rate reductions, investment incentives will remain high and the nation's savings can be utilized more efficiently. An efficient capital cost recovery system is essential to maintaining U.S. economic growth. As the world economies become increasingly competitive, it is most important that investment in our capital stock be determined by market forces rather than by tax considerations.

Under prior law, the tax benefits of the combination of the investment tax credit and accelerated depreciation were more generous for some equipment than if the full cost of the investment were deducted immediately—a result more generous than exempting all earnings on the investment from taxation. At the same time, assets not qualifying for the investment credit and accelerated depreciation bore much higher effective tax rates. The output attainable from our capital resources was reduced because too much investment occurred in tax-favored sectors and too little investment occurred in sectors that were more productive but which were tax-disadvantaged. The nation's output can be increased simply by a reallocation of investment, without requiring additional saving.

The Congress concluded that the surest way of encouraging the efficient allocation of all resources and the greatest possible economic growth was by reducing statutory tax rates. A large reduction in the top corporate tax rate was achieved by repealing the investment tax credit without reducing the corporate tax revenues collected. One distorting tax provision was replaced by lower tax rates that provide benefits to all investment. A neutral tax system allows the economy to most quickly adapt to changing economic needs.

Explanation of Provisions

1. Depreciation

Overview

The Act modifies ACRS for property placed in service after December 31, 1986, except for property covered by transition rules. The cost of property placed in service after July 31, 1986, and before January 1, 1987, which is not transition-rule property, may, at the election of the taxpayer on an asset-by-asset basis, be covered under the modified rules.

The Act provides more accelerated depreciation for the revised three-year, five-year and 10-year classes, reclassifies certain assets according to their present class life (or "ADR midpoints"), and creates a seven-year class, a 20-year class, a 27.5-year class, and a 31.5-year class. The Act prescribes depreciation methods for each ACRS class (in lieu of providing statutory tables). Eligible personal property and certain real property are assigned among the three-year class, five-year class, seven-year class, 10-year class, 15-year class, or 20-year class.

The depreciation method applicable to property included in the three-year, five-year, seven-year, and 10-year classes is the double declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. For property in the 15-year and 20-year class, the applicable depreciation method is the 150-percent declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. The cost of section 1250 real property generally is recovered over 27.5 years for residential rental property and 31.5 years for nonresidential property, using the straight-line method.

Under the Act, if a lessee makes improvements to leased property, the cost of the leasehold improvement is recovered under the same rules that apply to an owner of property.

General rules

The Act reclassifies certain assets based on midpoint lives under the ADR system, as in effect on January 1, 1986 (Rev. Proc. 83-35, 1983-1 C.B. 745). Certain ADR classifications are made on the basis of regulated accounts (*e.g.*, ADR class 49.14, regarding electric utility transmission and distribution plants). Under the Act, if an asset is described in a particular ADR class, it is assigned to an ACRS class without regard to whether the taxpayer who owns the asset is subject to regulation (*e.g.*, for property described in ADR class 49.14, without regard to whether the taxpayer is a public utility or an unregulated company). As under prior law, the salvage value of property is treated as zero; thus, the entire cost or other basis of eligible property is recovered under the Act.

Eligible property

Property eligible for modified ACRS generally includes tangible depreciable property (both real and personal), whether new or used, placed in service after December 31, 1986. Eligible property does not include (1) property that the taxpayer properly elects to depreciate under the unit-of-production method or any other method not expressed in terms of years (other than the "retirement replacement betterment" method or similar method), (2) any property used by a public utility (within the meaning of section 167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting, (3) any motion picture film or video tape, (4) any sound recording described in section 280(c)(2), or (5) any property subject to ACRS as in effect before enactment of the Act or pre-ACRS depreciation rules (by application of an effective date or transitional rule or the anti-churning rule). As under present law, intangible property may be amortizable under section 167.

The legislative history clarifies that under present law cargo containers have an ADR midpoint of six years and this present class life shall be used in applying the provisions of the Act.[2]

As under prior law, property that the taxpayer properly elects to depreciate under the unit-of-production method or any other method not expressed in terms of years (other than the retirement-replacement-betterment method or similar method), will be so depreciated. For example, depreciation is allowable with respect to landfills on a unit basis (without regard to whether the space for dumping waste was excavated by the taxpayer), to the extent capital costs are properly allocable to the space to be filled with waste rather than to the underlying land.

Normalization requirements for public utility property

The Act continues the rule that public utility property is eligible for ACRS only if the tax benefits of ACRS are normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. In addition to requiring the normalization of ACRS deductions, the Act provides for the normalization of excess deferred tax reserves resulting from the reduction of corporate income tax rates (with respect to prior depreciation or recovery allowances taken on assets placed in service before 1987).

If an excess deferred tax reserve is reduced more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method, the taxpayer will not be treated as using a normalization method of accounting with respect to any of its assets. Thus, if the excess deferred tax reserve is not normalized, the taxpayer must compute its depreciation allowances using the depreciation method, useful life determination, averaging convention, and salvage value limitation used for purposes of setting rates and reflecting operating results in regulated books of account.

The excess deferred tax reserve is the reserve for deferred taxes computed under prior law over what the reserve for deferred taxes would be if the tax rate in effect under the Act had been in effect for all prior periods. The average rate assumption method is the method which reduces the excess deferred tax reserve over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes. Under this method, the excess deferred tax reserve is reduced as the timing differences (i.e., differences between tax depreciation and regulatory depreciation with respect to each asset or group of assets in the case of vintage accounts) reverse over the life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. The excess deferred tax reserve is multiplied by a formula that is designed to insure that the excess is reduced to zero at the end of the regulatory life of the asset that generated the reserve.

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[2] H. Rep. 99-841, Vol. II (September 18, 1986), p. 40.

The Congress did not intend that the provisions apply retroactively to any excess deferred tax reserve generated from previous reductions in corporate tax rates; such excess deferred tax reserves will continue to be treated under prior law.

Classification of assets and recovery periods

For purposes of assigning assets to ACRS classes (and applying the alternative depreciation system, described below), the Act prescribes ADR midpoint lives for the following assets: (1) Semiconductor manufacturing equipment (described in ADR class 36.0), 5 years; (2) computer-based telephone central office switching equipment and related equipment (described in ADR class 48.12) the functions of which are those of a computer or peripheral equipment (as defined in section 168(i)(2)(B)) in their capacity as telephone central office equipment, 9.5 years; (3) Railroad track, 10 years; (4) Single-purpose agricultural and horticultural structures within the meaning of sec. 48(p) (described in ADR class 01.3), 15 years; (5) Telephone distribution plant (e.g., telephone fiber optic cable) (described in ADR class 48.14) and comparable equipment, 24 years (comparable equipment means equipment used by non-telephone companies for two-way exchange of voice and data communications (equivalent of telephone communications)—comparable equipment does not include cable television equipment used primarily for one-way communication); (6) Municipal waste-water treatment plant, 24 years; and (7) Municipal sewers, 50 years.

Personal property

Three-year class.—The Act retains the three-year class for property with an ADR midpoint of four years or less, but excludes automobiles, light general purpose trucks, and property used in connection with research and experimentation. Property used in connection with research and experimentation is included in the five-year class described below.

Five-year class.—The Act modifies the five-year class to include property with ADR midpoint lives of more than four but less than ten years, and adding automobiles, light trucks, qualified technological equipment, computer-baseed telephone central office switching equipment, research and experimentation property, and geothermal, ocean thermal, solar, and wind energy properties, and biomass properties described in section 48(l) that are used in connection with qualifying small power production facilities.

Telephone central office switching equipment and related equipment (described in ADR class 48.12) is computer-based only if its functions are those of a computer or peripheral equipment (as defined in section 168(i)(2)(B)) in its capacity as telephone central office switching equipment. The identical qualities of this computer-based equipment and computers are the basis for placing the computer-based equipment in the five-year class along with computers (rather than excluding such property because of its 18-year ADR midpoint life). Telephone central office switching equipment does not include private branch exchange (PBX) equipment.

Seven-year class.—The Act creates a new class for assets with ADR midpoints of at least 10 years but less than 16 years, and adding single-purpose agricultural or horticultural structures and property with no ADR midpoint that is not classified elsewhere.

Ten-year class.—The Act modifies the ten-year class to include only property with ADR midpoints of at least 16 years but less than 20 years.

15-year class.—Under the Act, the 15-year class includes property with ADR midpoints of at least 20 years and less than 25 years, and adding municipal wastewater treatment plants, and telephone distribution plant and comparable equipment used for the two-way exchange of voice and data communications.

20-year class.—The Act creates a 20-year class for property with ADR midpoints of 25 years and more, other than section 1250 real property with an ADR midpoint of 27.5 years and more, and adding municipal sewers.

Depreciation methods.—The cost of property in the three-year, five-year, seven-year, or ten-year class is recovered using the 200-percent declining balance method, switching to the straight-line method at a time to maximize the deduction.

The cost of property included in the 15-year or 20-year class is recovered using the 150-percent declining balance method, switching to the straight-line method at a time to maximize the deduction.

Real property

The Act provides different recovery periods for residential rental property and nonresidential real property.

Residential rental property.—Residential rental property is defined as a building or structure (including manufactured homes that are residential rental property, elevators, and escalators) with respect to which 80 percent or more of the gross rental income is rental income from dwelling units. The term "dwelling unit" is defined as a house or apartment used to provide living accommodations, but does not include a unit in a hotel, motel, inn, or other establishment more than one-half of the units in which are used on a transient basis. If any portion of a building or structure is occupied by the taxpayer, the gross rental income from such property shall include the rental value of the portion so occupied.

The cost of residential rental property is recovered using the straight-line method of depreciation, and a recovery period of 27.5 years.

Nonresidential real property.—Nonresidential real property is defined as section 1250 class property that either has no ADR midpoint or has an ADR midpoint of 27.5 years or more, and that is not residential rental property (including elevators and escalators).

The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 31.5 years.

Optional depreciation method

The Act repeals the provision that permitted taxpayers to elect use of the straight-line method over an optional recovery period. The election to use the straight-line method over the applicable ACRS recovery period is retained. Further, a taxpayer is permitted to elect use of an alternative depreciation system based on ADR midpoints (described below) for property that is otherwise eligible for ACRS.[3]

Changes in classification

The Secretary, through an office established in the Treasury Department is authorized to monitor and analyze actual experience with all tangible depreciable assets, to prescribe a new class life for any property or class of property (other than real property) when appropriate, and to prescribe a class life for any property that does not have a class life. If the Secretary prescribes a new class life for property, such life will be used in determining the classification of the property. The prescription of a new class life for property will not change the ACRS class structure, but will affect the ACRS class in which the property falls. Any classification or reclassification would be prospective.

Any class life prescribed under the Secretary's authority must reflect the anticipated useful life, and the anticipated decline in value over time, of an asset to the industry or other group. Useful life means the economic life span of property over all users combined and not, as under prior law, the typical period over which a taxpayer holds the property. Evidence indicative of the useful life of property, which the Secretary is expected to take into account in prescribing a class life, includes the depreciation practices followed by taxpayers for book purposes with respect to the property, and useful lives experienced by taxpayers, according to their reports. It further includes independent evidence of minimal useful life—the terms for which new property is leased, used under a service contract, or financed—and independent evidence of the decline in value of an asset over time, such as is afforded by resale price data. If resale price data is used to prescribe class lives, such resale price data should be adjusted downward to remove the effects of historical inflation. This adjustment provides a larger measure of depreciation than in the absence of such an adjustment. Class lives using this data would be determined such that the present value of straight-line depreciation deductions over the class life, discounted at an appropriate real rate of interest, is equal to the present value of what the estimated decline in value of the asset would be in the absence of inflation.

Initial studies are expected to concentrate on property that now has no ADR midpoint. Additionally, clothing held for rental and scientific instruments (especially those used in connection with a computer) should be studied to determine whether a change in class life is appropriate.

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[3] In addition, the Congress intended taxpayers to have an election to use the 150-percent declining balance method, switching to the straight-line method, over ADR midpoints, permitted for purposes of the minimum tax.

Certain other assets specifically assigned a recovery period (including horses in the three-year class, qualified technological equipment, computer-based central office switching equipment, research and experimentation property, certain renewable energy and biomass properties, semiconductor manufacturing equipment, railroad track, single-purpose agricultural or horticultural structures, telephone distribution plant and comparable equipment, municipal wastewater treatment plants, and municipal sewers) may not be assigned a longer class life by the Treasury Department if placed in service before January 1, 1992. Additionally, automobiles and light trucks may not be reclassified by the Treasury Department during this five-year period. Such property placed in service after December 31, 1991, and before July 1, 1992, may be prescribed a different class life if the Secretary has notified the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate of the proposed change at least 6 months before the date on which such change is to take effect.

Averaging conventions

The following averaging conventions apply to depreciation computations made under both ACRS (as modified by the Act) and the new alternative depreciation system (described below). The recovery period begins on the date property is placed in service under the applicable convention.

Half-year convention

In general, a half-year convention applies under which all property placed in service or disposed of during a taxable year is treated as placed in service or disposed of at the midpoint of such year. As a result, a half-year of depreciation is allowed for the first year property is placed in service, regardless of when the property is placed in service during the year, and a half-year of depreciation is allowed for the year in which property is disposed of or is otherwise retired from service. No depreciation is allowed in the case of property acquired and disposed of in the same year. In the case of a taxable year less than 12 months, property is treated as being in service for half the number of months in such taxable year.

To illustrate the application of the half-year convention, assume that a taxpayer places in service a $100 asset that is assigned to the five-year class. ACRS deductions, beginning with the first taxable year and ending with the sixth year, are $20, $32, $19.20, $11.52, $11.52, and $5.76. If the asset were disposed of in year two, the ACRS deduction for that year would be $16.

Mid-month convention

In the case of both residential rental property and nonresidential real property, a mid-month convention applies. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Further, property disposed of by a taxpayer at any time during a month is treated as having been disposed of in the middle of the month.

Special rule where substantial property placed in service during last three months of year

A mid-quarter convention is applied to all property if more than 40 percent of all depreciable property placed in service by a taxpayer during a taxable year is placed in service during the last three months of the taxable year. The mid-quarter convention treats all property placed in service during any quarter of a taxable year as placed in service on the midpoint of such quarter.

Where property is placed in service by a partnership, the 40-percent test generally will be applied at the partnership level, except in the case of partnerships that are formed or availed of to avoid the mid-quarter convention.

Where the taxpayer is a member of an affiliated group (within the meaning of sec. 1504),[4] all such members are treated as one taxpayer for purposes of the 40-percent determination. The required determination is made by reference to the parent corporation's taxable year. Further, it was intended that transfers of property between members of the same affiliated group filing a consolidated return be disregarded for purposes of the 40-percent determination.

For example, using the mid-quarter convention, a $100 asset in the five-year class eligible for the 200-percent declining balance method that is placed in service during the first quarter of a taxable year would receive deductions beginning in taxable year 1 and ending in taxable year 6 of $35, $26, $15.60, $11.01, $11.01, and $1.38.

For taxable years straddling January 1, 1987, in which property is placed in service subject both to prior-law ACRS and to the Act, the 40-percent determination is made with respect to all such property. The mid-quarter convention, however, applies only to property subject to the Act.

Alternative depreciation system

In general

In general, an alternative depreciation system is provided for property that (1) is used predominantly outside the United States ("foreign-use" property), (2) is leased to or otherwise used by a tax-exempt entity, including a foreign person unless more than 50 percent of the gross income derived from the property by such person is subject to U.S. tax ("tax-exempt use" property), (3) is financed directly or indirectly by an obligation the interest on which is exempt from taxation under section 103(a), to the extent of such financing ("tax-exempt bond financed" property), (4) is imported from a foreign country with respect to which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts, or (5) with respect to which an election to decelerate depreciation deductions is made. In these cases, depreciation allowances are computed under the alternative depreciation system, which provides for straight-line recovery (without regard to salvage value) and use of the applicable averaging conventions described above.

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[4] The Congress intended the determination (of whether a corporation is a member of an affiliated group) to be made by reference to section 1504(b) (which excludes certain corporations).

The recovery period under the alternative system generally is equal to the property's ADR midpoint life (12 years for personal property with no ADR midpoint life, and 40 years for real property—including real property that is section 1245 property with no ADR midpoint). In the case of property for which an ADR midpoint is prescribed by the Act, the prescribed midpoint is used as the recovery period under the alternative depreciation system. In addition, qualified technological equipment (as defined under the rules for tax-exempt use property), automobiles, and light purpose trucks are treated as having a recovery period of five years.

The alternative depreciation system is used for purposes of computing the earnings and profits of a corporation, as well as for purposes of computing the portion of depreciation allowances treated as an item of tax preference under the alternative minimum tax applicable to corporations and individuals. The Act also modifies the treatment of depreciation deductions for luxury automobiles and mixed-use property.

Foreign-use property

As under prior law, foreign-use property generally is defined as property that is used outside the United States more than half of a taxable year. In addition to retaining the exceptions to this general rule that were applicable under prior law, the Act provides a new exception for any satellite or other space craft (or any interest therein) held by a U.S. person if such property is launched from within the United States.

Tax-exempt use property

The Act retains the rules for tax-exempt use property, including the rules that (1) increase the recovery period used for purposes of computing depreciation to a period not less than 125 percent of the lease term, if this period would be longer than the depreciation period otherwise applicable to the property, and (2) treat qualified technological equipment with a lease term that exceeds five years as having a recovery period of five years.

For purposes of determining whether property is tax-exempt use property, in the case of a corporation the stock of which is publicly traded on an established securities market, the test of whether 50 percent or more (in value) of the stock of such corporation is held by tax-exempt entities is made by reference to tax-exempt entities that hold 5 percent or more (in value) of the stock in such corporation.

Tax-exempt bond financed property

The Act modifies the definition of tax-exempt bond financed property to include any property to the extent financed "directly or indirectly" by an obligation the interest on which is exempt from tax under section 103(a). Only the portion of the cost of property that is attributable to tax-exempt financing is recovered using this method. If only a part of a facility is financed with tax-exempt bonds, the tax-exempt bond financed portion will be allocated to the portion of the property that is first placed in service. An exception is provided to recover the cost of low-income housing financed with tax-exempt bonds over 27.5 years.

Minimum tax

For purposes of the depreciation preference under the minimum tax, the cost of property other than section 1250 real property (unless it is real property with an ADR midpoint of less than 27.5 years) is recovered using the 150-percent declining balance method, switching to the straight-line method. The cost of section 1250 real property and other property for which the straight-line method is either required or elected to be used for regular tax purposes is recovered using the straight-line method for minimum tax purposes.

Luxury automobiles and mixed-used property

The Act conforms the fixed limitations applicable to automobiles so that the price range of affected cars is unchanged. The new limitations are: $2,560 for the first recovery year, $4,100 for the second recovery year; $2,450 for the third recovery year; and $1,475 for each succeeding taxable year in the recovery period. In addition, the Act clarifies that the fixed limitations apply to all deductions claimed for depreciation of automobiles, not just ACRS deductions.

For mixed-use property that is used 50 percent or more for personal purposes, depreciation deductions are computed under the alternative depreciation system.

Certain imported property

The Act authorizes the President to provide by Executive Order for the application of the alternative depreciation system to certain property that is imported from a country maintaining trade restrictions or engaging in discriminatory acts. For purposes of this provision, the term imported property means any property that is completed outside the United States, or less than 50 percent of the basis of which is attributable to value added within the United States. In applying this test, the term "United States" is treated as including the Commonwealth of Puerto Rico and the possessions of the United States.

The Act authorizes reduced depreciation for property that is imported from a foreign country that (1) maintains non-tariff trade restrictions that substantially burden U.S. commerce in a manner inconsistent with provisions of trade agreements, including variable import fees, or (2) engages in discriminatory or other acts or policies unjustifiably restricting U.S. commerce (including tolerance of international cartels). If the President determines that a country is engaging in the proscribed actions noted above, he or she may provide for the application of alternative depreciation to any article or class of articles manufactured or produced in such foreign country for such period as may be provided by Executive Order.

In general, the terms of the provision relating to certain imported property are substantially identical to those of section 48(a)(7) relating to the investment tax credit.

Election to use alternative depreciation system

A taxpayer may irrevocably elect to apply the alternative system to any class of property for any taxable year. If the election is made, the alternative system applies to all property in the ACRS class placed in service during the taxable year. For residential rental property and nonresidential real property, this election may be made on a property-by-property basis. The election to use the alternative system is in addition to the irrevocable election to recover costs using the straight-line method over the ACRS recovery period (described above).

General asset accounts

The Act continues the Secretary's regulatory authority to permit a taxpayer to maintain one or more mass asset accounts for any property in the same ACRS class and placed in service in the same year. As under prior law, unless otherwise provided in regulations, the full amount of the proceeds realized on disposition of property from a mass asset account are to be treated as ordinary income (without reduction for the basis of the asset). As a corollary, no reduction is to be made in the depreciable basis remaining in the account. The limitations on the ability to establish mass asset accounts under prior law, as proposed in Treasury regulations, resulted, in part, from a concern about the mechanics of recapturing investment tax credits on dispositions of property from an account. To facilitate the application of the recapture rules without requiring that individual assets be identified, the proposed regulations provide mortality dispersion tables that cannot be applied easily to diverse assets. In view of the repeal of the investment tax credit, the primary reason for restricting a taxpayer's ability to establish vintage accounts is set aside. Accordingly, the Act contemplates that the definition of assets eligible for inclusion in mass asset accounts will be expanded to include diverse assets.

Lessee leasehold improvements

The cost of leasehold improvements made by a lessee is to be recovered under the rules applicable to other taxpayers, without regard to the lease term. On termination of the lease, the lessee who does not retain the improvements is to compute gain or loss by reference to the adjusted basis of the improvement at that time.

In light of the treatment of a lessee's capital costs, the only future relevance of section 178 will be in determining the amortization period for lease acquisition costs. Accordingly, Act makes conforming changes to section 178. Under revised section 178, the term of a lease is determined by including all renewal options as well as any other period for which the parties reasonably expect the lease to be renewed.

Treatment of certain transferees

A special rule applies after the transfer of any property in a nonrecognition transaction described in section 332, 351, 361, 371(a), 374(a), 721, or 731 (other than the case of a termination of a partnership under 708(b)(1)(B)). In any such case, the transferee is treated as the transferor for purposes of computing the depreciation deduction with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. Thus, the transferee of property in one of the transactions described above "steps into the shoes" of the transferor to the extent the property's basis is not increased as the result of the transaction.[5] The Congress intended the special rule to apply to any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group. To the extent the transferee's basis exceeds the property's basis in the hands of the transferor (e.g., because the transferor recognized gain in the transaction), the transferee depreciates the excess under the general ACRS rules.

Additions or improvements to property

The Act preserves the prohibition against use of the component method of depreciation. The recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service. Any ACRS deduction for an addition or improvement to a property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of a post-effective date improvement to a building that constitutes nonresidential real property is recovered over 31.5 years using the straight-line method (i.e., the same recovery period and method that would apply to the building if it were placed in service after the effective date, unless a transitional rule applies to such improvement).

Expensing in lieu of cost recovery

The Act continues the provision under which a taxpayer (other than a trust or estate) can elect to treat the cost of qualifying property as an expense that is not chargeable to capital account, with four modifications. The costs for which the election is made are allowed as a deduction for the taxable year in which the qualifying property is placed in service.

Under the first modification, the dollar limitation on the amount that can be expensed is $10,000 a year ($5,000 in the case of a married individual filing a separate return).

The second modification limits the amount eligible to be expensed for any taxable year in which the aggregate cost of qualifying property placed in service during such taxable year exceeds $200,000. For every dollar of investment in excess of $200,000, the $10,000 ceiling is reduced by $1.

The third modification limits the amount eligible to be expensed to the taxable income derived from an active trade or business. For purposes of this rule, taxable income from the conduct of an active trade or business is computed without regard to the cost of the expensed property.

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[5] The Congress intended this rule to apply to transfers of property that was subject to section 168 as in effect before the amendments made by the Act in the hands of the transferor.

Costs that are disallowed as a result of the limitation based on taxable income are carried forward to the succeeding taxable year (and added to the amount eligible to be expensed under this provision for that year).

Under the fourth modification, if property is converted to nonbusiness use at any time before the end of the recovery period, the difference between the amount expensed and the ACRS deductions that would have been allowed for the period of business use is recaptured as ordinary income.

Disposition of assets and recapture

As under prior law, if a taxpayer uses ACRS to recover the costs of tangible property (other than residential rental property and nonresidential real property), all gain on the disposition of such property is recaptured as ordinary income to the extent of previously allowed depreciation deductions. For purposes of this rule, any deduction allowed under section 179 (relating to the expensing of up to $10,000 of the cost of qualifying property), 190 (relating to the expensing of the costs of removing certain architectural and transportation barriers), or 193 (relating to tertiary injectant expenses) is treated as a depreciation deduction.

There is no recapture of previously allowed depreciation deductions in the case of residential rental property and nonresidential real property.

2. Regular investment tax credit

The Act repeals the regular investment tax credit.

3. Finance leases

The Act repeals the finance lease rules.

Effective Dates

In general

The provisions that modify ACRS apply to all property placed in service after December 31, 1986. The provision that repeals the regular investment tax credit is effective for property placed in service after December 31, 1985. Repeal of the finance lease rules is effective for property placed in service after December 31, 1986. The Act also provides an election to apply the modified ACRS to certain property that is placed in service after July 31, 1986; such an election would disqualify property under the investment tax credit transitional rules. All elections made under section 168 of the Code, as amended, are irrevocable and must be made on the first tax return for the taxable year in which the property is placed in service.

Transitional rules

The Act provides certain exceptions to the general effective dates, in the case of property constructed, reconstructed, or acquired pursuant to a written contract that was binding as of March 1, 1986, (December 31, 1985, for purposes of the investment tax credit) or in other transitional situations discussed below. Except in the case of qualified solid waste disposal facilities and certain satellites (described below), the application of the transitional rules is conditioned on property being placed in service by a prescribed date in the future. In addition, special rules are provided for investment credits claimed on transitional property, for tax-exempt bond financed property, and for the finance lease rules.

Taxpayers may have difficulty in identifying under their accounting systems whether a particular item placed in service on or after January 1, 1987, (1986, for the investment tax credit) was acquired pursuant to a contract that was binding before March 2, 1986, (January 1, 1986, for the investment tax credit) or meets the rule for self-constructed property. The problem arises where a taxpayer regularly enters into contracts for (or manufactures itself) large stocks of identical or similar items of property to be placed in service as needed. The taxpayer's accounting system may not identify the date on which the contract for an item's acquisition was entered into (or the date on which manufacture commenced). In such a situation, a taxpayer is to assume that the first items placed in service after December 31, 1986, (1985, for the investment tax credit) were those they had under a binding contract on that date. A similar rule is to apply to self-constructed property.

Except as otherwise provided, for purposes of the depreciation transitional rules, the rules described below do not apply to any property unless the property has an ADR midpoint of seven years or more and is placed in service before the applicable date, determined according to the following: (1) for property with an ADR midpoint less than 20 years (other than computer-based telephone central office switching equipment), January 1, 1989, and (2) for property with an ADR midpoint of 20 years or more, residential rental property, and nonresidential real property, January 1, 1991.

For purposes of the investment tax credit transitional rules, the applicable placed-in-service dates are: (1) for property with an ADR midpoint less than five years, July 1, 1986, (2) for property with an ADR midpoint of at least five but less than seven years and including computer-based telephone central office switching equipment, January 1, 1987, (3) for property with an ADR midpoint of at least seven but less than 20 years (other than computer-based telephone central office switching equipment), January 1, 1989, and (4) for property with an ADR midpoint of 20 years or more, January 1, 1991.

For purposes of a placed-in-service requirement, if any transitional rule substitutes an applicable date for a project, then the substitute date is used. Further, all property included in a taxpayer-specific transitional rule under section 204(a) of the Act is treated as having an ADR midpoint of 20 years; thus, all such property qualifies for the placed-in-service window that closes on December 31, 1990. Similarly, property that is incorporated into an equipped building or plant facility need not independently satisfy the placed-in-service requirements. Instead, such property would qualify for transition relief as part of the equipped building or plant facility—as long as the equipped building or plant facility is placed in service by the applicable date prescribed for the building or facility.

For purposes of the general effective dates, if at least 80 percent of a target corporation's stock is acquired on or before December 31, 1986, (December 31, 1985, for purposes of the investment tax credit) and the acquiring corporation makes a section 338 election to treat the stock purchase as an asset purchase after the relevant date, then the deemed new target corporation is treated as having purchased the assets before the general effective date.

As under prior law, property that is leased to a tax-exempt entity and was not "tax-exempt use property" within the meaning of Section 168(j) of the Code (as in effect immediately prior to the enactment of the Act) because of the application of a transitional rule contained in Section 31(g) of the Tax Reform Act of 1984 will not become "tax-exempt use property" within the meaning of Section 168(h) (as amended by the Act) merely by reason of a transfer of the property subject to the lease so long as the lessee does not change, but only to the extent the transfer would have received similar protection under the 1984 Act.

Anti-churning rules

The Act expands the scope of the prior law anti-churning rules to prevent taxpayers from bringing certain property placed in service after December 31, 1980, under the modified ACRS. The expanded anti-churning rules apply to all ACRS property, other than residential rental property and nonresidential real property, where the result would be to qualify such property for more generous depreciation than would be available under prior law. In determining whether property would qualify for more generous depreciation, the Congress intended that taxpayers compare ACRS deductions for the first taxable year (whether a short year or a full year), assuming a half-year convention. The Act retains the anti-churning rules applicable to property that was originally placed in service before January 1, 1981.[6]

Regarding the applicable depreciation regime if the anti-churning rules apply, for property that was originally placed in service before January 1, 1981, the Congress intended the pre-1981 depreciation rules to apply. For property originally placed in service after December 31, 1980, the Congress intended ACRS—before amendment by the Act—to apply. Further, the anti-churning rules are intended to apply to property placed in service after July 31, 1986, but before January 1, 1987, with respect to which an election is made to apply the modified ACRS.

Binding contracts

The amendments made by the Act do not apply to property that is constructed, reconstructed, or acquired by a taxpayer pursuant to a written contract that was binding as of March 1, 1986 (December 31, 1985, for investment tax credits), and at all times thereafter. If a taxpayer transfers his rights in any such property under construction or such contract to another taxpayer, the Act does not apply to the property in the hands of the transferee, as long as the property was not placed in service by the transferor before the transfer by the transferor. For purposes of this rule, if by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of a partnership under section 708(b)(1)(B), the partnership is to be treated as having transferred its rights in the property under construction or the contract to the new partnership.

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[6] The anti-churning rules are not implicated by the conversion of property from personal use to business use; however, the Congress did not intend such property to qualify for more generous prior-law depreciation upon conversion to business use. For example, a taxpayer who acquired a residence for personal use before January 1, 1987, and converted the residence to business use after that date, will depreciate the property under the amendments made by the Act if prior-law depreciation would be more generous.

The general binding contract rule applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract.

A contract is binding only if it is enforceable under State law against the taxpayer, and does not limit damages to a specified amount (e.g., by use of a liquidated damages provisions). A contractual provision that limits damages to an amount equal to at least five percent of the total contract price is not treated as limiting damages.

For purposes of the general binding contract rule, a contract under which the taxpayer is granted an option to acquire property is not to be treated as a binding contract to acquire the underlying property. In contrast, a contract under which the taxpayer grants an irrevocable put (i.e., an option to sell) to another taxpayer is treated as a binding contract, as the grantor of such an option does not have the ability to unilaterally rescind the commitment. In general, a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor (except in the limited circumstances described below). A contract that was binding as of March 1, 1986 (or December 31, 1985, in the case of the investment tax credit) will not be considered binding at all times thereafter if it is substantially modified after that date.

A binding contract to acquire a component part of a larger property will not be treated as a binding contract to acquire the larger property under the general rule for binding contracts. For example, if a written binding contract to acquire an aircraft engine was entered into before March 2, 1986, there would be a binding contract to acquire only the engine, not the entire aircraft.

Design changes to a binding contract to construct a project that are made for reasons of technical or economic efficiencies of operation and that cause an insignificant increase in the original price will not constitute substantial modifications of the contract so as to affect the status of the project under the binding contract rule. In addition, a supplementary contract that stands on its own and is not protected by the binding contract rule, for example, to build an addition to a project protected by the binding contract rule, will not adversely affect the status of the portion of the project subject to a separate binding contract.

The general binding contract rule does not apply to supply agreements with manufacturers, where such contracts fail to specify the amount or design specifications of property to be purchased; such contracts are not to be treated as binding contracts until purchase orders are actually placed. A purchase order for a specific number of properties, based on the pricing provisions of the supply agreement, will be treated as a binding contract.

Self-constructed property

The Act is inapplicable to property that is constructed or reconstructed by the taxpayer, if (1) the lesser of $1 million or five percent of the cost of the property was incurred or committed, (i.e., required to be incurred pursuant to a written binding contract in effect) as of March 1, 1986 (December 31, 1985, for purposes of the investment tax credit) and (2) the construction or reconstruction began by that date. For purposes of this rule, a taxpayer who serves as the engineer and general contractor of a project is to be treated as constructing the property. For purposes of this rule, the construction of property is considered to begin when physical work of a significant nature starts. Construction of a facility or equipment is not considered as begun if work has started on minor parts or components. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, researching, or developing.

For purposes of the rule for self-constructed property, in the context of a building, the term "property" includes only the building shell, its structural components, and the normal and customary components that are purchased from others and installed without significant modification (*e.g.*, light fixtures) (*see* the discussion below, relating to equipped buildings, for the treatment of machinery and equipment to be used in the completed building).

Example.—Prior to January 1, 1986, an aircraft manufacturer entered into binding contracts with third parties for the construction of aircraft subassemblies to be included by the manufacturer in the construction of the completed aircraft. The cost to the aircraft manufacturer of these subassemblies is approximately $300,000, which together with the costs of other components of the aircraft which the manufacturer had incurred or was required to incur pursuant to a written binding contract on December 31, 1985, exceeds 5 percent of the cost of the aircraft. These subassemblies were designed for this model of aircraft, were specifically ordered for the aircraft and are essential to its operation, and include wing trailing edges, ailerons and tabs, and rudders and tabs. The subcontractors commenced physical construction of these subcomponents prior to January 1, 1986. Prior to the date the aircraft is placed in service, the manufacturer will transfer it to its wholly-owned subsidiary that is included in the same consolidated tax return as the manufacturer.

The aircraft qualifies for the investment tax credit under the transitional rule for self-constructed property. Construction of the aircraft would be considered to have begun by the aircraft manufacturer when the subcontractors commenced physical construction of the subassemblies on behalf of the manufacturer pursuant to the binding written contract.[7]

Equipped buildings

Where construction of an equipped building began on or before March 1, 1986 (December 31, 1985, for purposes of the investment tax credit), pursuant to a written specific plan, and more than one-half the cost of the equipped building (including any machinery and equipment for it) was incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) the entire equipped building project and incidental appurtenances are excepted from the Act's application.[8] This rule is not limited to manufacturing facilities. Where the costs incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) do not equal more than half the cost of the equipped building, each item of machinery and equipment and the building is treated separately for purposes of determining whether the item qualifies for transitional relief.

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[7] Floor Statement by Senator Packwood, Cong. Rec. S 13955-56 (September 27, 1986); Floor Statement by Mr. Rostenkowski, Cong. Rec. H 8360 (September 25, 1986).

Under the equipped building rule, the Act will not apply to equipment and machinery to be used in the completed building, and also incidental machinery, equipment, and structures adjacent to the building (referred to here as appurtenances) which are necessary to the planned use of the building, where the following conditions are met:

(1) The construction (or reconstruction or erection) or acquisition of the building, machinery, and equipment was pursuant to a specific written plan of a taxpayer in existence on March 1, 1986 (December 31, 1985, for the investment tax credit); and

(2) More than 50 percent of the adjusted basis of the building and the equipment and machinery to be used in it (as contemplated by the written plan) was attributable to property the cost of which was incurred or committed by March 1, 1986 (December 31, 1985, for the investment tax credit), and construction commenced on or before March 1, 1986 (December 31, 1985, for the investment tax credit).

The written plan for an equipped building may be modified to a minor extent after March 1, 1986 (December 31, 1985, for the investment tax credit) and the property involved may still come under this rule; however, there cannot be substantial modification in the plan if the equipped building rule is to apply. The plan referred to must be a definite and specific plan of the taxpayer that is available in written form as evidence of the taxpayer's intentions.

The equipped building rule can be illustrated by an example where the taxpayer has a plan providing for the construction of a $100,000 building with $80,000 of machinery and equipment to be placed in the building and used for a specified manufacturing process. In addition, there may be other structures or equipment, here called appurtenances, which are incidental to the operations carried on in the building, that are not themselves located in the building. Assume that the incidental appurtenances have further costs of $30,000. These appurtenances might include, for example, an adjacent railroad siding, a dynamo or water tower used in connection with the manufacturing process, or other incidental structures or machinery and equipment necessary to the planned use of the building. Of course, appurtenances, as used here, do not include a plant needed to supply materials to be processed or used in the building under construction. In this case, if construction of the building is under a binding contract and property but no equipment had been ordered, and the appurtenances had not been constructed or placed under binding order, the equipped building rule would apply. This is true because the building cost represents more than 50 percent of the total $180,000. As a result, the machinery and equipment, even though not under binding contract, is eligible for the rule. In this connection, it should be noted that the additional cost of appurtenances, $30,000, is not taken into account for purposes of determining whether the 50-percent test is met. Nevertheless, the Act would not apply to these appurtenances since the 50-percent test is met as to the equipped building.

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[8] For example, if property with a class life of less than 7 years is incorporated into an equipped building, then such property would not independently need to satisfy the placed-in-service requirements. Instead, such property would qualify for transition relief as part of the equipped building—as long as the equipped building is placed in service by the prescribed date.

Plant facilities

The Act also provides a plant facility rule that is comparable to the equipped building rule (described above), for cases where the facility is not housed in a building. For purposes of this rule, the term "plant facility" means a facility that does not include any building (or of which buildings constitute an insignificant portion), and that is a self-contained single operating unit or processing operation—located on a single site—identifiable as a single unitary project as of March 1, 1986.

If pursuant to a written specific plan of a taxpayer in existence as of March 1, 1986 (December 31, 1985, for the investment tax credit), the taxpayer constructed, reconstructed, or erected a plant facility, the construction, reconstruction, or erection commenced as of March 1, 1986 (December 31, 1985, for the investment tax credit), and the 50-percent test is met, then the conference agreement will not apply to property that makes up the facility. For this purpose, construction, etc., of a plant facility is not considered to have begun until it has commenced at the site of the plant facility. (This latter rule does not apply if the facility is not to be located on land and, therefore, where the initial work on the facility must begin elsewhere.) In this case, as in the case of the commencement of construction of a building, construction begins only when actual work at the site commences; for example, when work begins on the excavation for footings, etc., or pouring the pads for the facility, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings), does not constitute the beginning of construction, reconstruction or erection.

The application of the plant facility rule is clarified where the original construction of a power plant is pursuant to a written specific plan of a taxpayer in existence as of March 1, 1986 (December 31, 1985, in the case of the investment tax credit), and both the original construction and more than one-half of the total cost of the property to be used at the power plant has been incurred or committed by such date. The plant facility rule will apply to the power plant even though the type of fuel to be utilized at the plant may have changed subsequent to the original plan and other changes may be made to accommodate the change in the fuel source, as long as more than one-half of the total cost of the plant, including all conversion costs, were incurred or committed by March 1, 1986. The plant facility rule also will apply to the plant in the hands of a transferee, upon its transfer prior to the time that construction is completed and before it is placed in service.

Special rules for sale-leasebacks within three months

Property is treated as meeting the requirements of a transitional or general effective date rule if (1) the property is placed in service by a taxpayer who acquired the property from a person in whose hands the property would qualify under a transitional or general effective date rule, (2) the property is leased back by the taxpayer to such person, and (3) the leaseback occurs within three months after such property was originally placed in service, but no later than the applicable date. The special rule for sale-leasebacks is intended to apply to any property that qualifies for transitional relief under the Act or that was originally placed in service by the lessee under the sale-leaseback before the general effective date. This rule would apply where a taxpayer acquires property from a manufacturer, places the property in service by leasing it to the ultimate user, and subsequently engages in a sale-leaseback within three months after the property was originally placed in service under the initial lease.

In the case of a facility that would otherwise qualify for transitional relief as an equipped building (described above), if a portion of such equipped building is sold and leased back in accordance with the requirements of the special rule for sale-leasebacks, both the leased and retained portions will continue to qualify for transitional relief as an equipped building.

Special rules for tax-exempt bond financed property

The provision restricting ACRS deductions for property financed with tax-exempt bonds applies to property placed in service after December 31, 1986, to the extent such property is financed (directly or indirectly) by the proceeds of bonds issued after March 1, 1986. The revised restrictions on ACRS deductions do not apply to facilities placed in service after December 31, 1986, if—

(1) the original use of the facilities commences with the taxpayer and the construction (including reconstruction or rehabilitation) commenced before March 2, 1986, and was completed after that date;

(2) a binding contract to incur significant expenditures for the construction (including reconstruction or rehabilitation) of the property financed with the bonds was entered into before March 2, 1986, was binding at all times thereafter, and some or all of the expenditures were incurred after March 1, 1986; or

(3) the facility was acquired after March 1, 1986, pursuant to a binding contract entered into before March 2, 1986, and that is binding at all times after March 1, 1986.

For purposes of this restriction, the determination of whether a binding contract to incur significant expenditures existed before March 2, 1986, is made in the same manner as under the rules governing the redefinition of industrial development bonds.

The restrictions on ACRS deductions for bond-financed property do not apply to property placed in service after December 31, 1986, to the extent that the property is financed with tax-exempt bonds issued before March 2, 1986. ACRS deductions for such property may be determined, however, under the rules generally provided by the Act. For purposes of this exception, a refunding issue issued after March 1, 1986, generally is treated as a new issue and the taxpayer must use the alternative depreciation method provided by the Act for costs that are unrecovered on the date of the refunding issue.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the alternative depreciation system provided by the Act. Therefore, no retroactive adjustments to ACRS deductions previously claimed are required when a pre-March 2, 1986, bond issue is refunded where no significant expenditures are made with respect to the facility after December 31, 1986.

Contract with persons other than a person who will construct or supply the property

The Act provides transitional relief for certain situations where written binding contracts require the construction or acquisition of property, but the contract is not between the person who will own the property and the person who will construct or supply the property. This rule applies to written service or supply contracts and agreements to lease entered into before March 2, 1986 (January 1, 1986, in the case of the investment tax credit). An example of a case to which this rule would apply would be lease agreements under which a grantor trust is obligated to provide property under a finance lease (to the extent continued under the bill). This rule applies to cable television franchise agreements embodied in whole or in part in municipal ordinances or similar enactments before March 2, 1986 (January 1, 1986, for the investment tax credit).

This transitional rule is applicable only where the specifications and amount of the property are readily ascertainable from the terms of the contract, or from related documents. A supply or service contract or agreement to lease must satisfy the requirements of a binding contract (discussed above). A change in the method or amount of compensation for services under the contract, without more, will not be considered a substantial modification of the contract if, taken as a whole, the change does not affect the scope or function of the project. This rule does not provide transitional relief to property in addition to that covered under a contract described above, which additional property is included in the same project but does not otherwise qualify for transitional relief.

As a further example, where a taxpayer before January 1, 1986 entered into a written binding contract to construct a wastewater treatment facility and to provide wastewater treatment services, the subsequent amendment of the contract to (1) extend the date for completion of construction by a short period (*e.g.*, three months), (2) provide for a letter of credit or other financial protection against defaults of the service provider, (3) add a pledge of net revenue and a sewer use rate covenant by the service recipient, (4) cause the service recipient's options to purchase the facility to comply with "service contract" definitional requirements of the Internal Revenue Code, (5) merely clarify rights and remedies in the event of performance defaults, and (6) treat the obligations of the taxpayer to accept and treat wastewater as separate obligations (and treat similarly the obligation of the service recipient to pay for such services) would not in the aggregate constitute a "substantial modification," if the taxpayer's obligations to provide wastewater treatment services and to construct or acquire the facility are not affected thereby.

Development agreements relating to large-scale multi-use urban projects

The Act does not apply to property that is included in a "qualified urban renovation project." The term qualified urban renovation project includes certain projects that satisfy the following requirements as of March 1, 1986 (December 31, 1985, for the investment tax credit): the project is described in the Act and (1) was publicly announced by a political subdivision, for the renovation of an urban area in its jurisdiction, (2) was either the subject of an agreement for development or a lease between such political subdivision and the primary developer of the project, or was undertaken pursuant to the political subdivision's grant of development rights to a primary developer-purchaser; or (3) was identified as a single unitary project in the internal financing plans of the primary developer, and (4) is not substantially modified at any time after March 1, 1986 (December 31, 1985, for the investment tax credit).

Federal Energy Regulatory Commission application or action

The requirements of the general binding contract rule will be treated as satisfied with respect to a project if, on or before March 1, 1986 (for purposes of depreciation and the investment tax credit), the Federal Energy Regulatory Commission ("FERC") licensed the project or certified the project as a "qualifying facility" for purposes of the Public Utility Regulatory Policies Act of 1978 ("PURPA"). A project that a developer has simply put FERC on notice as a qualifying facility is not *certified* as a qualifying facility.

This rule will not apply if a FERC license or certification is substantially amended after March 1, 1986. On the other hand, minor modifications will not affect the application of this rule (e.g., technical changes in the description of a project, extension of the deadline for placing property in operation, changes in equipment or in the configuration of equipment).

FERC does not distinguish between an application to amend an existing certificate and one to have a project recertified and responds in both cases by "recertifying" the project. The Congress intends that substance should control over form, and property will remain transitional property if no substantial change occurs. Similarly, a mere change in status from a "qualifying small power production facility" to a "qualifying cogeneration facility," under PURPA, without more, would not affect application of the transitional rule. The following paragraph provides guidance about how the "substance over form" rule applies in typical cases.

The requirements of the transitional rule for FERC Certification will not be violated under the following circumstances: (1) after FERC certification, the introduction of efficiencies results in a reduction of the project cost and an increase in net electricity output, and the FERC certificate is amended to reflect the higher electricity output, (2) a project was originally certified as three separate facilities, but the taxpayer determines that it is more efficient to have a single powerhouse, and the FERC certification is amended to have the facilities combined under a single certificate.

The Act also provides transitional relief for hydroelectric projects of less than 80 megawatts if an application for a permit, exemption, or license was filed with FERC before March 2, 1986 (for purposes of depreciation and the investment tax credit).

Qualified solid waste disposal facilities

The Act does not apply to a qualified solid waste disposal facility if, before March 2, 1986 (for purposes of depreciation and the investment tax credit) (1) there is a written binding contract between a service recipient and a service provider, providing for the operation of such facility and the payment for services to be provided by the facility, or (2) a service recipient, governmental unit, or any entity related to such an entity made a financial commitment of at least $200,000 to the financing or construction of the facility.

For purposes of this rule, a qualified solid waste disposal facility is a facility (including any portion of the facility used for power generation or resource recovery) that provides solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the solid waste processed at such facility is collected from the general public. This rule does not apply to replacement property. For example, assume a taxpayer/service provider enters into a long-term service contract before January 1, 1986, and a facility is initially placed in service after that date. Assume that the taxpayer finds it necessary to replace the facility 20 years later, pursuant to its obligation to provide continuing services under the pre-1987 service contract. The special rule will apply only to the first facility necessary to fulfill the taxpayer's obligations under the service contract.

For purposes of this provision, a contract is to be considered as binding notwithstanding the fact that the obligations of the parties are conditioned on factors such as the receipt of permits, satisfactory construction or performance of the facility, or the availability of acceptable financing. A change in the method or amount of compensation for services under the contract will not be considered a substantial modification of the contract if, taken as a whole, the change does not materially affect the scope or function of the project.

A service recipient or governmental unit or a related party is to be treated as having made a financial commitment of at least $200,000 for the financing or construction of a facility if one or more entities have issued bonds or other obligations aggregating more than 10 percent of the anticipated capital cost of such facility, the proceeds of which are identified as being for such facility or for a group of facilities that include the facility, and if the proceeds of such bonds or other obligations to be applied to the development or financing of such facility are at least $200,000 in the aggregate. Alternatively, the test would be satisfied if one or more entities have expended in the aggregate at least $200,000 of their funds, or utilized or committed at least $200,000 of their assets, toward the development or financing of such facility (*e.g.*, for the cost of feasibility studies and consultant fees). If a governmental entity acquires a site for a facility by purchase, option to purchase,[9] purchase contract, condemnation, or entering into an exchange of land, it shall be considered to have made a financial commitment equal to the fair market value of such site for purposes of this rule. For purposes of this provision, entities are related if they are described in section 168(h)(4)(A)(i).

Other exceptions

The Act also provides other special transitional rules of limited application.

Property treated under prior tax Acts.—The Act does not apply to (1) those mass commuting vehicles exempted from the application of the tax-exempt leasing rules under DEFRA, (2) a qualified lessee's automotive manufacturing property that was exempted from deferral of the finance lease rules,[10] (3) a qualified lessee's farm property that was exempted from deferral of the finance lease rules, or (4) property described in section 216(b)(3) of TEFRA. Property that qualifies under one of these provisions is also intended to be excepted from the 35-percent reduction of the investment credit and the full-basis adjustment (described below).[11]

Master plans.—Under the special rule for master plans for integrated projects, (1) in the case of multi-step plans described in sec. 204(a)(5)(E) of the Act, the rule will include executive approval of a plan or executive authorization of expenditures under the plan before March 2, 1986, and (2) in the case of single-step plans described in sec. 204(a)(5)(E) of the Act, the rule will include project-specific designs for which expenditures were authorized, incurred or committed before March 2, 1986.

A master plan for a project will be considered to exist on March 1, 1986 if the general nature and scope of the project was described in a written document or documents in existence on March 1, 1986, or was otherwise clearly identifiable on that date. Each of the projects described in this rule had a master plan in existence on March 1, 1986, and the existence of such a plan is not intended to be a separate requirement for transitional relief for property comprising these projects.

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[9] In the case of an option to purchase, the governmental entity will be treated as having made a financial commitment only if an amount is paid for the option and such consideration is forfeitable.

[10] Property that qualified for exemption from deferral of the finance lease rules under the general transition rule included in section 12(c)(1) of the 1984 Act (by virtue of a binding contract entered into before March 7, 1984) falls within the general binding contract rule in section 203(b)(1) of the Act. Thus, the finance lease rules would continue to apply to this property if the property is placed in service by the applicable date.

[11] *See* Floor Statement by Mr. Rostenkowski, Cong. Rec. E3393 (October 2, 1986). Technical corrections are recommended to clarify this result, as well as the intent to conform the reference to section 209(d)(1)(B) of TEFRA (relating to finance leases of farm equipment) in section 204(b) to the reference in 204(a)(4) (to include the reference to further amendments made by the Tax Reform Act of 1984).

Satellites.—The Act provides transitional relief (including exceptions to the placed-in-service requirements) for certain satellites. Solely for purposes of the special rule for satellites, a binding contract for the construction or acquisition of two satellites by a joint venture shall be sufficient if such contract was in existence on July 2, 1986, and is for the construction or acquisition of the same satellites that were the subject of a contract to acquire or construct in effect on January 28, 1986, to which one of the joint venturers (or one of its affiliates) was a party.

The satellite transition rule was drafted with the understanding that in many instances launch agreements were executed years in advance of launch and that substitution of satellites in such agreements was, and is, a common practice within the industry. The Congress intended to recognize the possibility of alternative launch agreements. For example, NASA launch manifests revisions, made pursuant to an Executive Order of the President, were announced on October 3, 1986, and necessitated such alternative launch agreements. Under the satellite transition rule, it is not necessary that the agreement in existence on January 28, 1986, be the same agreement under which launch actually occurs.

Commercial passenger airliners.—The Act extends the placed-in-service window for one year (through 1989) for commercial passenger airliners described in ADR class 45.0.

Special rules applicable to the regular investment credit

Full basis adjustment

A taxpayer is required to reduce the basis of property that qualifies for transition relief ("transition property") by the full amount of investment credits earned with respect to the transition property (after application of the phased-in 35-percent reduction, described below).[12] The full-basis adjustment requirement also applies to credits claimed on qualified progress expenditures made after December 31, 1985. Further, the full-basis adjustment requirement applies to all depreciable property, regardless of whether such property is eligible for ACRS. The lower basis will be used to compute depreciation deductions, as well as gain or loss on disposition of property.[13]

Reduction of ITC carryforwards and credits claimed under transitional rules

These rules apply only to the portion of an investment credit attributable to the regular percentage (other than the portion thereof attributable to qualified timber property). Thus, for example, 100 percent of ITC carryovers may continue to be allowed for funding of an investment tax credit employee stock ownership plan.

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[12] Under a literal interpretation of the statute, a full basis adjustment is required with respect to the energy percentage (as modified by section 421(a) of the Act), but only where the underlying asset also constitutes "transition property" within the meaning of new section 49. Congress did not intend this result; the full-basis adjustment rule only applies to the portion of an investment credit attributable to the regular percentage. *Cf.* Section 421(b) of the Act (which explicitly incorporates the full-basis adjustment rule for application to certain energy credits allowed under the affirmative commitment provisions).

[13] The Congress intended that if a credit for which a full basis adjustment was required (1) is recaptured, there will be an upward basis adjustment of 100 percent of the recapture amount, or (2) expires at the end of the carryover period, a deduction will be allowed for 100 percent of the unused credit.

Under the Act, the investment tax credit allowable for carryovers and transition property is reduced by 35 percent.[14] The reduction in the investment tax credit is phased in with the corporate rate reduction to provide an approximately equal deduction equivalent value of the credit. The 35-percent reduction is fully effective for taxable years beginning on or after July 1, 1987. Taxpayers having a taxable year that straddles July 1, 1987, will be subject to a partial reduction that reflects the reduction for the portion of their year after that date. For example, for a taxpayer using the calendar year as a taxable year, the reduction for 1987 is 17.5 percent. For taxable years that straddle July 1, 1987, the Congress intended that the amount added to carryforwards (under new section 49(c)(4)(B)(ii)) bear the same ratio to the carryforwards from the taxable year (before inclusion of the additional amount) as the reduction of the credit under new section 49(c)(3) bears to the sum of the current year credit for the taxable year and the carryforwards to the taxable year, less the reduction of the credit under new section 49(c)(3). Further, new section 49(c)(3) should be taken into account in applying new section 49(c)(4)(A) (providing that the amount of the reduction shall not be allowed as a credit for any taxable year).

Thus, a taxpayer utilizing the investment tax credit in any year receives approximately the same deduction equivalent value of the investment tax credit. Combined with the full basis adjustment, these provisions ensure that taxpayers placing property in service in the same taxable year are treated similarly.

Example.—Assume a taxpayer places transition property in service on January 1, 1987, generating a $100 regular investment tax credit. In the first instance, the credit is reduced by 17.5 percent to $82.50. Because of the application of the 75% limitation on general business tax credits, assume further that only $60 of the credit is used in 1987. Thus, $22.50 is carried forward to 1988. Further, an additional amount equal to $4.77 (determined as described above) is carried forward to 1988. The entire $27.27 ($22.50 + $4.77) is then reduced by 35 percent.

The amount by which the credit is reduced will not be allowed as a credit for any other taxable year. For purposes of determining the extent to which an investment credit determined under section 46 is used in a taxable year, the regular investment credit is assumed to be used first. This rule is inapplicable to credits that a taxpayer elects to carryback 15 years under the special rules described below.

As described above, a full basis adjustment is required with respect to the reduced amount of the investment tax credit arising in the year property is placed in service. Thus, for transition property placed in service after 1987 and eligible for a 6.5 percent investment tax credit, the basis reduction would be with respect to the 6.5 percent credit, not the unreduced 10-percent credit.

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[14] The Congress intended to apply the phased-in 35-percent reduction to investment tax credits used in a taxable year beginning after December 31, 1986, irrespective of when the property with respect to which the credit is claimed was placed in service, or whether the credit was carried forward pursuant to sections 38 and 39, or some other section (*e.g.*, section 465 or prior law section 168(i)).

The phased-in 35-percent reduction is to be applied to the investment tax credit before application of the general 75-percent limitation. Further, the amount of investment tax credit carryovers subject to reduction shall first be adjusted to reflect credits that were recaptured.

Section 48(d) election

A taxpayer in whose hands property qualifies for transitional relief can make an election under section 48(d) to pass the credit claimed to a lessee. In applying section 48(d)(5), which coordinates the section 48(d) election with the section 48(q) basis adjustment, Congress intended the income inclusion to equal 100 percent of the credit allowed to the lessee.[15a]

Estimated tax payments

The repeal of the regular investment tax credit for property placed in service after December 31, 1985, presents an issue about the manner in which estimated tax payments should be calculated for payment due dates occurring before the date of enactment of this Act. In general, for example, a corporation calculates estimated tax by determining its expected regular tax liability, less any allowable tax credits. Any underpayment of estimated corporate tax generally results in the imposition of penalties.

The Act provides a general provision that waives estimated tax penalties for underpayments that are attributable to changes in the law that increase tax liabilities from the beginning of 1986 (sec. 1543 of the Act).[15b] Individual taxpayers have until April 15, 1987, and corporations until March 15, 1987 (the final filing dates for calendar years returns) to pay 1986 income tax liabilities without incurring additions to tax due to underpayments.

Elective 15-year carryback for certain taxpayers

Certain companies can elect a 15-year carryback of 50 percent of investment tax credit carryforwards in existence as of the beginning of a taxpayer's first taxable year beginning after December 31, 1985. The amount carried back is treated as a payment against the tax imposed by chapter 1 of the Internal Revenue Code, made on the last day prescribed by law (without regard to extensions) for filing a return of tax under chapter 1 of the Code for the first taxable year beginning on or after January 1, 1987. The amount carried back would reduce tax liability for the first taxable year beginning after December 31, 1986; to the extent the amount carried back exceeds the tax liability for such year, any excess could be claimed as a refund under generally applicable rules. Carryforwards taken into account under the carryback rule are not taken into account under section 38 for any other taxable year. Generally, taxpayers eligible to elect the 15-year carryback are domestic corporations whose raw steel production in the United States during 1983 exceeded 1.5 million tons. A similar election is available to qualified farmers, except a $750 limitation applies.

[15a] A technical corection may be necessary so that the statute reflects this intent.

[15b] It should be noted that the Statement of Managers for the depreciation provisions (on page II-64) is incorrect in stating that taxpayers have only 30 days after the date of enactment to avoid penalties for underpayments. *See* floor statement by Mr. Rostenkowski, 132 Cong. Rec. H.8359 (September 25, 1986).

The amount claimed as a payment against the tax for the first taxable year beginning on or after January 1, 1987 cannot exceed the taxpayer's net tax liability. The net tax liability is the amount of tax liability for all taxable years during the carryback period (not including minimum tax liability), reduced by the sum of credits allowable (other than the credit under section 34 relating to certain fuel taxes). The carryback period is the period that (1) begins with the taxpayer's 15th taxable year preceding the first taxable year from which there is a credit included in the taxpayer's existing carryforward (in no event can such period begin before the first taxable year ending after December 31, 1961), and (2) ends with the corporation's last taxable year beginning before January 1, 1986.

Normalization requirement for public utility property

If the tax benefits of previously allowed investment tax credits on public utility property are not normalized, then certain investment tax credits will be recaptured. In general, the amount recaptured is the greater of (1) all investment tax credits for open taxable years of the taxpayer or (2) unamortized credits of the taxpayer or credits not previously restored to rate base (whether or not for open years), whichever is applicable. If such credits have not been utilized and are being carried forward, the carryforward amount is reduced in lieu of recapture. These rules apply to violations of the relevant normalization requirements occurring in taxable years ending after December 31, 1985. Similar principles apply to the failure to normalize the tax benefits of previously allowed employee stock ownership plan credits.

General treatment of QPEs

Neither the repeal of the regular investment credit nor the phased-in 35-percent reduction of credits affects QPEs claimed with respect to the portion of the basis of any progress expenditure property attributable to progress expenditures for periods before January 1, 1986. The fact that the property on which QPEs are claimed is placed in service after 1985 is immaterial. Carryovers of credits attributable to QPEs are subject to the general rules providing for a reduction in carryforwards. If a taxpayer elected to take a reduced rate of credit on a QPE basis in lieu of the 50-percent basis adjustment of prior law, the portion of basis attributable to such QPEs, claimed for periods before 1986, will not be reduced and such election will not apply to any other portion of such basis. After December 31, 1985, QPEs cannot be claimed unless it is reasonable to expect that the property will be placed in service before the applicable date. The determination of whether it is reasonable to expect that the placement-in-service requirement will be met is to be made on a year-by-year basis, beginning with the first taxable year that includes January 1, 1986. For any taxable year in which reasonable expectations change, no QPEs will be allowed, and previously claimed post-1985 QPEs will be recaptured. Further, if the property is not placed in service on or before the last applicable date, post-1985 QPEs will be recaptured in the taxable year that includes such date.

Special rules for television and motion picture films

Special transitional rules apply to television and motion picture films for purposes of the investment credit (but not depreciation). For purposes of the general binding contract rule, (1) construction is treated as including production, (2) in accordance with industry practice, written contemporaneous evidence of a binding contract is treated as a written binding contract, and (3) in the case of any television film, a license agreement or agreement for production services between a television network and a producer (including written evidence of such an agreement as provided in (2) above) is treated as a binding contract to produce property. For these purposes, license agreement options are binding contracts as to the optionor (non-exercising party) but not as to the optionee (exercising party).[16] In addition, a special rule is provided for certain films produced pursuant to a permanent financing arrangement described by the bill. For purposes of the placed-in-service requirement, films and sound recordings are treated as having ADR midpoints of 12 years.

Finance leases

The finance lease rules continue to apply to any transaction permitted by reason of section 12(c)(2) of DEFRA or section 209(d)(1)(B) of TEFRA.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $18,879 million in 1987, $21,413 in 1988, $30,501 million in 1989, $37,692 million in 1990, and $46,802 million in 1991.

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[16] For example, television films produced by a film producer pursuant to a license agreement with a television network (including cable) that was in writing and binding on December 31, 1985, or produced in-house by a television network using production services provided pursuant to an agreement for production services between the network and a producer that was in writing and binding on that date, will be eligible for credit if placed in service before January 1, 1989. (In accordance with industry practice, written contemporaneous evidence of a binding contract is treated as a written binding contract.) Television films not the subject of a contract binding on December 31, 1985, that are placed in service after December 31, 1985, but before January 1, 1989, are eligible for credit only if the lesser of $1 million or 5 percent of the cost of producing such films was incurred or committed by December 31, 1985, and production began by that date.

B. Limitation on General Business Credit

Prior Law

The general business tax credit earned by a taxpayer could be used to reduce up to $25,000 of tax liability, plus 85 percent of tax liability in excess of $25,000.

Explanation of Provision

The Act reduces the 85-percent limitation on the general business credit to 75 percent.

Effective Date

The provision is effective for taxable years that begin after December 31, 1985.

Revenue Effect

The effect of this provision is included in the estimate for the corporate minimum tax.

C. Research and Development

1. Tax credit for increasing research expenditures; university basic research credit (sec. 231 of the Act and sec. 30 of the Code)[17]

Prior Law

Expensing deduction

Under prior and present law, a taxpayer may elect to deduct currently the amount of research or experimental expenditures incurred in connection with its trade or business (sec. 174), notwithstanding the general rule that business expenditures to develop or create an asset that has a useful life extending beyond the taxable year must be capitalized. (Alternatively, the taxpayer may elect to treat these expenditures as deferred expenses and deduct them over a period of not less than 60 months on a straight-line basis.) This provision was enacted in the 1954 Code in order to eliminate the need to distinguish research from business expenses for deduction purposes, and to encourage taxpayers to carry on research and experimentation activities.[18]

The Code does not specifically define "research or experimental expenditures" eligible for the section 174 deduction election, except to exclude certain costs. Treasury regulations (sec. 1.174-2(a)) define "research or experimental expenditures" to mean "research and development costs in the experimental or laboratory sense." The regulations provide that this includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned." Other research or development costs—i.e., research or development costs not "in the experimental or laboratory sense"–do not qualify under section 174.

The section 174 election does not apply to expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research.[19] Thus, for example, the total cost of a research building or of equipment used for research cannot be deducted currently under section 174 in the year of acquisition. However, the amount of depreciation (cost recovery) allowance for a year with respect to depreciable property used for research may be deducted in that year under sections 167 and 168.

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[17] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 231; H.Rep. 99-426, pp. 176-85; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1301; S.Rep. 99-313, pp. 693-702; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 68-76 (Conference Report).

[18] H. Rpt. No. 1337, 83d Cong., 2d Sess. at 28 (1954); S. Rpt. 1622, 83d Cong., 2d Sess. at 33 (1954); *Snow* v. *Comm'r*, 416 U.S. 500 (1974) (citing Congressional intent to encourage research by both "oncoming" and "ongoing" businesses); *Green* v. *Comm'r*, 83 T.C. 667 (1984) (intent of sec. 174 was to encourage "up-and-coming" small businesses to engage in research, not to allow passive investor entities to obtain current deductions).

[19] The statute also excludes expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas, from eligibility for section 174 elections (sec. 174(d)). However, expenses of developing new and innovative methods of extracting minerals from the ground may be eligible for sec. 174 elections (Rev. Rul. 74-67, 1974-1 C.B. 63). Certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under sec. 616.

The present regulations further provide that qualifying research expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, the section 174 election cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. sec. 1.174-2(a)).

Incremental tax credit

Under a provision enacted in the Economic Recovery Tax Act of 1981, a taxpayer could claim a nonrefundable 25-percent income tax credit for certain research expenditures paid or incurred in carrying on an existing trade or business.[20] The credit applied only to the extent that the taxpayer's qualified research expenditures for the taxable year exceeded the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). Under prior law, the credit was not available for expenses paid or incurred after December 31, 1985.

Research expenditures eligible for the incremental credit under prior law consisted of (1) in-house expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) in the case of a corporate taxpayer, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

The prior-law credit provision adopted the definition of research used for purposes of the section 174 expensing provision, but subject to three exclusions: (1) expenditures for research which is conducted outside the United States; (2) research in the social sciences or humanities; and (3) research to the extent that it is funded by any grant, contract, or otherwise by another person (or any governmental entity).

Under prior and present law, the credit is available for incremental qualified research expenditures for the taxable year whether or not the taxpayer has elected under section 174 to deduct currently research expenditures. The amount of any section 174 deduction to which the taxpayer is entitled is not reduced by the amount of any credit allowed for qualified research expenditures.

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[20] As enacted in the 1981 Act, the credit was set forth in section 44F of the Code. The Deficit Reduction Act of 1984 renumbered the credit provision as Code section 30. The Tax Reform Act of 1986 renumbered the credit, as amended, as section 41 of the Code.

Under prior law, the incremental research credit was not subject to the general limitation on use of business credits (85 percent of tax liability over $25,000).

Reasons for Change

Three-year extension; reduction in rate of credit.—When the incremental research credit was enacted in 1981, the Congress expressed serious concern about the then substantial relative decline in total U.S. expenditures for research and experimentation. The purpose of enacting the credit was to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy. An expiration date for the credit was deemed desirable in order to enable the Congress to evaluate the operation of the credit, and to determine whether it should be extended and, if so, what modifications would be necessary to make the credit more effective.

The Congress concluded that an additional three-year extension of the credit is desirable in order to obtain more complete and comprehensive information to evaluate whether the credit should be further extended or modified. In the context of the base broadening and rate reduction provisions of the Act, and the continued allowance of full expensing of research expenditures, the credit rate is reduced to 20 percent.

Eligibility of certain computer-use costs.—Under prior law, expenditures for renting research equipment were eligible for the credit, but depreciation allowances for purchased research equipment were not. The Congress believed that such inconsistent treatment should not be continued, and that the taxpayer's investment decision to purchase or lease should not be skewed by availability of the credit. The Act makes such rental costs, etc. ineligible for the credit, except for certain payments by the taxpayer to another person for the use of computer time in research. Continued eligibility for the latter payments is intended to benefit small businesses that cannot afford to purchase or lease their own computers for research purposes, and hence is intended to apply where the taxpayer is not the principal user of the computer.

Research definition for credit purposes.—After reviewing available information and testimony on the actual use of the credit to date, the Congress concluded that the statutory credit provision should set forth an express definition of qualified research expenses for purposes of the credit. The Congress believed that the definition has been applied too broadly in practice, and some taxpayers have claimed the credit for virtually any expenses relating to product development. According to early data on the credit reported by the Treasury Department, research by these taxpayers often does not involve any of the attributes of technological innovation.

Accordingly, the Act targets the credit to research undertaken for the purpose of discovering information that is technological in nature and when applied is intended to be useful in developing a new or improved business component for sale or use in carrying on the taxpayer's trade or business. In addition, research is eligible for the extended credit only when substantially all the activities undertaken in developing or improving the business component constitute elements of a process of experimentation relating to functional aspects of the business component. The Act provides exclusions from the credit for certain research or nonresearch activities, and limits allowance of the credit for the costs of developing certain internal-use computer software to such software meeting a high threshold of innovation.

University basic research.—The Congress believed it is desirable to provide increased tax incentives for corporate cash expenditures for university basic research where such expenditures do not merely represent a switching of donations from general university giving and where certain other maintenance-of-effort levels are exceeded. By contrast to other types of research or product development, where expected commercial returns attract private investment, basic research typically does not produce sufficiently immediate commercial applications to make investment in such research self-supporting. Because basic research typically involves greater risks of not achieving a commercially viable result, larger-term projects, and larger capital costs than ordinary product development, the Federal Government traditionally has played a lead role in funding basic research, principally through grants to universities and other nonprofit scientific research organizations. In addition, the research credit as modified by the Act provides increased tax incentives for corporate funding of university basic research to the extent that such expenditures reflect a significant commitment by the taxpayer to basic research.

Credit use limitation.—The Congress concluded that the general limitation on use of business credits (under the Act, 75 percent of tax liability over $25,000) should apply to the research credit.

Explanation of Provisions

Three-year extension; reduction in rate of incremental credit

The Act extends the incremental research tax credit for three additional years, i.e., for qualified research expenditures paid or incurred through December 31, 1988, at a credit rate of 20 percent.

Eligibility of certain computer-use costs

The Act generally repeals the prior-law provision treating amounts paid by the taxpayer to another person for the right to use personal property in qualified research as generally eligible for the credit. However, the Act provides that, under regulations to be prescribed by the Treasury Department, amounts paid or incurred by the taxpayer to another person for the right to use computer time in the conduct of qualified research are eligible for the incremental credit. This provision is intended to benefit smaller businesses that cannot afford to purchase or lease their own computers for research purposes, and hence is intended to apply where the taxpayer is not the principal user of the computer. Consistent with the prior-law limitations on credit-eligibility of research equipment rental costs, such computer-use payments are not eligible for the credit to the extent that the taxpayer (or a person with which the taxpayer must aggregate expenditures in computing the credit) receives or accrues any amount from any other person for computer use.

In computing the incremental research credit for a taxable year beginning after December 31, 1985 (when rental costs will not be eligible for the credit), a taxpayer may exclude from the base-period amount with respect to such year any rental costs, etc. (other than for computer-use costs of a type remaining eligible for the credit in post-1985 years) that were allowable as qualified research expenses under section 30(b)(2)(A)(iii) (as then in effect) in a base-period year.[21]

Definition of research for credit purposes

In general

The Act targets the credit to research undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in developing a new or improved business component for sale or use in carrying on the taxpayer's trade or business. In addition, research is eligible for the extended credit only where substantially all the activities undertaken in developing or improving the business component constitute elements of a process of experimentation relating to functional aspects of the business component. The Act provides exclusions from the credit for certain research or nonresearch activities. The costs of developing certain internal-use software are eligible for the credit only if specified requirements are met.

No inference is intended from the provisions of the Act defining research eligible for the credit as to the scope of the term "research or experimental" for purposes of the section 174 expensing deduction.

Research

As under prior law, the Act limits research expenditures eligible for the incremental credit to "research or experimental expenditures" eligible for expensing under section 174. Thus, for example, the credit is not available for (1) expenditures other than "research and development costs in the experimental or laboratory sense," (2) expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions," (3) costs of acquiring another person's patent, model, production, or process, or (4) research expenditures incurred in connection with literary, historical, or similar projects (Treas. Reg. sec. 1.174-2(a)).[22] The term research includes basic research.

Under the Act, research satisfying the section 174 expensing definition is eligible for the credit only if the research is undertaken for the purpose of discovering information (a) that is technological in nature, and also (b) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, such research is eligible for the credit only if substantially all of the activities of the research constitute elements of a process of experimentation for a functional purpose. The Act also expressly sets forth exclusions from eligibility for the credit for certain research activities that might otherwise qualify and for certain nonresearch activities.

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[21] Except pursuant to the rule stated in the text for the exclusion of certain rental costs from base-period expenditures, the Act does not authorize modifications to base-period computations for taxable years beginning prior to 1986 (see text below under "Effective Date").

[22] As noted above, sec. 174 also excludes from eligibility for expensing (1) expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research, and (2) expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas.

Technological nature

The determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science[23] —in which case the information is deemed technological in nature—or on other principles, such as those of economics—in which case the information is not to be treated as technological in nature. For example, information relating to financial services or similar products (such as new types of variable annuities or legal forms) or advertising does not qualify as technological in nature.

Process of experimentation

The term process of experimentation means a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the start. This may involve developing one or more hypotheses, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall component.

Thus, for example, costs of developing a new or improved business component are not eligible for the credit if the method of reaching the desired objective (the new or improved product characteristic) is readily discernible and applicable as of the beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose among viable alternatives. On the other hand, costs of experiments undertaken by chemists or physicians in developing and testing a new drug are eligible for the credit because the researchers are engaged in scientific experimentation. Similarly, engineers who design a new computer system, or who design improved or new integrated circuits for use in computer or other electronic products, are engaged in qualified research because the design of those items is uncertain at the outset and can only be determined through a process of experimentation relating to specific design hypotheses and decisions as described above.

Functional purposes

Under the Act, research is treated as conducted for a functional purpose only if it relates to a new or improved function, performance, or reliability or quality. Activities to assure achievement of the intended function, performance, etc. of the business component undertaken after the beginning of commercial production of the component are not eligible for the credit. The Act also provides that research relating to style, taste, cosmetic, or seasonal design factors shall in no event be treated as conducted for a functional purpose and hence is not eligible for the credit.

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[23] Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken to discover information that is technological in nature, however, if the research is intended to expand or refine existing principles of computer science.

Application of tests

The term business component means a product, process, computer software, technique, formula, or invention that is to be held for sale, lease, or license, or is to be used by the taxpayer in a trade or business of a taxpayer. If the requirements described above for credit eligibility are not met with respect to a product, etc. but are met with respect to one or more elements thereof, the term business component means the most significant set of elements of such product, etc. with respect to which all requirements are met.

Thus, the requirements for credit eligibility are applied first at the level of the entire product, etc. to be offered for sale, etc. by the taxpayer. If all aspects of such requirements are not met at that level, the test applies at the most significant subset of elements of the product, etc. This shrinking back of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test. Treasury regulations may prescribe rules for applying these rules where a research activity relates to more than one business component.

A plant process, machinery, or technique for commercial production of a business component is treated as a different component than the product being produced. Thus, research relating to the development of a new or improved production process is not eligible for the credit unless the definition of qualified research is met separately with respect to such production process research, without taking into account research relating to the development of the product.

Internal-use computer software

Under a specific rule in the Act, research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's own internal use is eligible for the credit only if the software is used in (1) qualified research (other than the development of the internal-use software itself) undertaken by the taxpayer, or (2) a production process that meets the requirements for the credit (e.g., where the taxpayer is developing both robotics and software for the robotics to be used in a manufacturing process, and the taxpayer's research costs of developing the robotics are eligible for the credit). Any other research activities with respect to internal-use software are ineligible for the credit except to the extent provided in Treasury regulations. Accordingly, the costs of developing computer software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services), except to the extent permitted by Treasury regulations.

The Congress intended and expected that these regulations will make the costs of new or improved internal-use software eligible for the credit only if the taxpayer can establish, in addition to satisfying the general requirements for credit eligibility, (1) that the software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant); (2) that the software development involves significant economic risk (as where the taxpayer commits substantial resources to the development and also there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period); and (3) that the software is not commercially available for use by the taxpayer (as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirements just stated). The Congress intended that these regulations are to apply as of the effective date of the new specific statutory rule relating to internal-use software; i.e, internal-use computer software costs that qualify under the three-part test set forth in this paragraph are eligible for the research credit even if incurred prior to issuance of such final regulations.

The specific rule in the Act relating to internal-use computer software is not intended to apply to the development costs of a new or improved package of software and hardware developed together by the taxpayer as a single product, of which the software is an integral part, that is used directly by the taxpayer in providing technological services in its trade or business to customers. For example, the specific rule would not apply where a taxpayer develops together a new or improved high technology medical or industrial instrument containing software that processes and displays data received by the instrument, or where a telecommunications company develops a package of new or improved switching equipment plus software to operate the switches. In these cases, eligibility for the incremental research tax credit is to be determined by examining the combined hardware-software product as a single product, and thus the specific rule applicable to internal-use computer software would not apply to the combined hardware-software product.

In the case of computer software costs incurred in taxable years before the effective date for the new specific statutory rule, the eligibility of such costs for the research credit is to be determined in the same manner as the eligibility of hardware product costs. The Congress expected and was assured by the Treasury Department that guidance to this effect would be promulgated on an expedited basis.

Excluded activities

The Act specifies that expenditures incurred in certain research, research-related, or nonresearch activities are excluded from eligibility for the credit, without reference to the requirements described above relating to technological information, process of experimentation, and functional purposes.

Post-production research activities.—The Act provides that any research with respect to a business component conducted after the beginning of commercial production of the component does not constitute qualified research eligible for the credit. Thus, no expenditures relating to a business component are eligible for the credit after the component has been developed to the point where it either meets the basic functional and economic requirements of the taxpayer for such component or is ready for commercial sale or use.[24] For example, the credit is not available for such expenditures as the costs of preproduction planning for a finished business component, tooling-up for production, trial production runs, trouble-shooting involving detecting faults in production equipment or processes, accumulation of data relating to production processes, and the cost of debugging product flaws.

By way of further illustration, the credit is not available for costs of additional clinical testing of a pharmaceutical product after the product is made commercially available to the general public. However, the clinical testing in the United States of a product prior to production for sale in this country, or clinical testing seeking to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms as improvements to an existing product, is eligible for the credit. Thus, research (e.g., body chemistry research) undertaken on a product approved for one specified indication to determine its effectiveness and safety for other potential indications is eligible for the credit. Similarly, testing a drug currently used to treat hypertension for a new anti-cancer application, and testing an antibiotic in combination with a steroid to determine its therapeutic value as a potential new anti-inflammatory drug, are eligible for the credit.

Adaptation.—The Act provides that research related to the adaptation of an existing business component to a particular customer's requirement or need is not eligible for the credit. Thus, for example, the costs of modifying an existing computer software item for a particular customer are not eligible for the credit. However, the mere fact that a business component is intended for a specific customer does not disqualify otherwise qualified research costs of the item (assuming that the research is not funded by the customer).

Surveys, studies, certain other costs.—The Act provides that the credit is not available for the costs of efficiency surveys; activities (including studies) related to management functions or techniques; market research, market testing, or market development (including advertising or promotions); routine data collections; or routine or ordinary testing or inspection of materials or business components for quality control. Management functions and techniques include such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line).

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[24] The exclusion from credit-eligibility for activities with respect to a business component after the beginning of commercial production of the component does not preclude the costs of improvements in an existing product from eligibility for the credit. Thus, for example, the expenses of an automobile manufacturer in developing, through a process of experimentation, a more efficient and reliable diesel fuel injector are eligible for the incremental research tax credit even though the research expenses are incurred during or after production by the manufacturer of automobile engines containing the existing (unimproved) diesel fuel injector. However, the costs of any activities of the automobile manufacturer with respect to the improved diesel fuel injector after the beginning of commercial production of the improved diesel fuel injector are not eligible for the research credit.

Duplication.—The Act provides that the credit does not apply to research related to the reproduction of an existing business component (in whole or in part) of another person from a physical examination of the component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such component. While such "reverse engineering" activities thus are not eligible for the credit, the exclusion for duplication does not apply merely because the taxpayer examines a competitor's product in developing its own component through a process of otherwise qualified experimentation requiring the testing of viable alternatives and based on the knowledge gained from such tests.

Additional exclusions.—As under prior law, the Act excludes from eligibility for the credit expenditures for research (1) that is conducted outside the United States; (2) in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities; or (3) to the extent funded by any person (or governmental entity) other than the taxpayer, whether by grant, contract, or otherwise.

Effect on section 174 definition

No inference is intended from the rules in the Act defining research for purposes of the incremental credit as to the scope of the term "research or experimental" for purposes of the section 174 expensing deduction.

University basic research credit

In general

Under prior law, research expenditures entering into the computation of the incremental research credit included 65 percent of a corporation's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations. Under the Act, a 20-percent tax credit applies to the *excess* of (1) 100 percent of corporate cash payments for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.[25]

Qualifying payments

For purposes of the credit, qualifying basic research payments are cash payments paid during the taxable year pursuant to a written agreement between the taxpayer corporation[26] and a university or certain other qualified organizations for basic research to be performed by the qualified organization (or by universities receiving funds through certain initial recipient qualified organizations). Such corporate payments for university basic research are deemed to satisfy the trade or business test for the research credit, whether or not the basic research is in the same field as an existing trade or business of the corporation.

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[25] The Act provides a single research credit (Code sec. 41), consisting of a 20-percent incremental component and a 20-percent university basic research component. For convenience, this explanation generally refers to these components as the incremental research credit and the university basic research credit.

[26] For this purpose, the term corporation does not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

Under the Act, qualifying basic research payments include both grants or contributions for basic research by the corporate taxpayer that constitute charitable contributions under section 170, and also contract payments for basic research to be performed by the qualified organization on behalf of the corporation. Such payments are not eligible for a credit unless and until actually paid by the corporation to a qualified organization. Thus, an accrual-basis corporation may not treat amounts incurred, but not actually paid during the taxable year, for university basic research as eligible for the credit in that year.

Under the Act, only cash payments may qualify as a basic research payment. No amount (basis or value) on account of contributions or transfers of property is eligible for either the incremental credit or the basic research credit, whether or not such property constitutes scientific equipment eligible for an augmented charitable deduction under section 170(e)(4).

As under prior law, the term basic research is defined in the Act as any original investigation for the advancement of scientific knowledge not having a specific commercial objective. However, expenditures for basic research in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities and basic research conducted outside the United States are excluded from eligibility for the credit.

Qualified organizations

To be eligible for a credit, the corporate payments must be for basic research to be conducted by a qualified organization. For this purpose, the term qualified organization generally includes colleges or universities, tax-exempt scientific research organizations, and certain tax-exempt conduit or grant organizations, as specified in the Act.

The first category of qualified organizations consists of educational institutions that both are described in Code section 170(b)(1)(A)(ii) and constitute institutions of higher education within the meaning of section 3304(f).[27] The second category consists of tax-exempt organizations that (1) are organized and operated primarily to conduct scientific research, (2) are described in section 501(c)(3) (relating to exclusively charitable, educational, scientific, etc., organizations), and (3) are not private foundations. Also, certain tax-exempt grant funds that qualified under prior law continue to qualify under the Act.

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[27] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." The term includes public or private colleges and universities (Treas. Reg. sec. 1.170A-9(b)(1)).

Sec. 3304(f) defines "institution of higher education" as an educational institution which (1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate; (2) is legally authorized to provide a program of education beyond high school; (3) provides an educational program for it which awards a bachelor's or higher degree, or provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and (4) is a public or other nonprofit institution.

In addition, the Act treats as a qualified organization any tax-exempt organization that is organized and operated primarily to promote scientific research by colleges or universities pursuant to written research agreements, that expends on a current basis substantially all its funds (or substantially all the basic research payments received by it) through grants to or contracts with colleges and universities for basic research, and that is either (a) described in section 501(c)(3) and is not a private foundation or (b) described in section 501(c)(6) (trade associations).

Computation rules for revised basic research credit

Under the Act, the university basic research credit applies to the *excess* of (1) 100 percent of corporate cash payments for university basic research *over* (2) the sum of the minimum basic research amount plus the maintenance-of-effort amount.

The minimum basic research amount is the *greater* of two fixed floors—

(a) the average of all credit-eligible basic research expenditures under Code section 30(e)(1) (as in effect during the base period) for the three taxable years immediately preceding the taxpayer's first taxable year beginning after December 31, 1983; or

(b) one percent of the average of the sum of all in-house research expenses, contract research expenses, and credit-eligible basic research expenditures under Code section 30(e)(1) (as in effect during the base period) for each of the three taxable years immediately preceding the taxpayer's first taxable year beginning after December 31, 1983.

In the case of a corporation that was not in existence for at least one full taxable year during this fixed base period, the Act provides that the minimum basic research amount for the base period shall not be less than 50 percent of the basic research payments for the current taxable year. If the corporation was in existence for one full taxable year or two full taxable years during such base period, the fixed floor is to be computed with respect to such year or years.

The maintenance-of-effort amount means, with respect to the taxpayer's current taxable year, the *excess* of the average of the nondesignated university donations paid by the taxpayer during the three taxable years immediately preceding the taxpayer's first taxable year beginning after December 31, 1983, as adjusted under the Act to reflect inflation, *over* the amount of nondesignated university donations paid by the taxpayer in the current taxable year. The term nondesignated university donation means all amounts paid by the taxpayer to all colleges or universities for which a charitable deduction was allowable (under sec. 170) and that were not taken into account in computing the research credit.

Any amount of credit-eligible basic research payments to which the revised university basic research credit applies does not enter into the computation of the incremental credit. Any remaining amount of credit-eligible basic research payments—i.e., the amount to which the revised credit does not apply because it does not exceed the qualified organization base period amount—is treated as contract research expenses, for purposes of section 41(a)(1), in computing the taxpayer's incremental credit (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

Credit limitations

The Act makes the research credit subject to the general business credit limitation (Code sec. 38), as amended by the Act (i.e., 75 percent of tax liability over $25,000).

Effective Date

The extension of the credit is effective for taxable years ending after December 31, 1985. Under the Act, the credit will not apply to amounts paid or incurred after December 31, 1988.[28]

The modifications to the credit made by the Act are effective for taxable years beginning after December 31, 1985, except that the modifications relating to the university basic research credit are effective for taxable years beginning after December 31, 1986. In computing the research credit for taxable years beginning after December 31, 1985, base-period expenditures for taxable years beginning before January 1, 1986 are to be determined under the prior-law credit definition of qualified research that was applicable in such base-period years and are not to be redetermined under the definition of qualified research in the Act.[29]

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $1,429 million in 1987, $1,183 million in 1988, $833 million in 1989, $429 million in 1990, and $259 million in 1991.

2. Augmented charitable deduction for certain donations of scientific equipment (sec. 231(f) of the Act and sec. 170(e)(4) of the Code)[30]

Prior Law

Under prior and present law, the amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary gain that the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)). Under a special rule, corporations are allowed an augmented charitable deduction for certain donations of newly manufactured scientific equipment to a college or university for research use in the physical or biological sciences (sec. 170(e)(4)).

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[28] The Act provides that in the case of any taxable year which begins before January 1, 1989, and ends after December 31, 1988, any amount for any base period with respect to such taxable year shall be the amount which bears the same ratio to such amount for such base period as the number of days in such taxable year before January 1, 1989, bears to the total number of days in such taxable year.

[29] Base-period expenditures for such years may be redetermined to exclude certain rental costs (see text accompanying note 21 above).

[30] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 231(f); H.Rep. 99-426, p. 185; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 76-77 (Conference Report).

Reasons for Change

The Congress believed that the prior-law provision concerning certain charitable donations of newly manufactured scientific equipment to universities for research use should be extended to include such donations to tax-exempt scientific research organizations.

Explanation of Provision

Under the Act, the category of eligible donees under section 170(e)(4) is expanded to include organizations described in Code section 41(e)(6)(B), i.e., tax-exempt organizations that (1) are organized and operated primarily to conduct scientific research, (2) are described in section 501(c)(3) (relating to exclusively charitable, educational, scientific, etc., organizations), and (3) are not private foundations.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The revenue effect of this provision is included with the revenue effect for item 1 above.

3. Tax credit for orphan drug clinical testing (sec. 232 of the Act and sec. 28 of the Code)[31]

Prior Law

A 50-percent, nonrefundable tax credit is allowed for a taxpayer's qualified clinical testing expenses paid or incurred in the testing of certain drugs (generally referred to as "orphan drugs") for rare diseases or conditions (Code sec. 28). Prior law defined a rare disease or condition is one that occurs so infrequently in the United States that there is no reasonable expectation that businesses could recoup the costs of developing a drug for it from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS (Lou Gehrig's disease), Tourette's syndrome, and Duchenne's dystrophy (a form of muscular dystrophy).

Under prior law, the orphan drug credit would not have been available for amounts paid or incurred after December 31, 1987.

Reasons for Change

The Congress decided to extend the orphan drug credit for three additional years, to be consistent with the longer authorization period for research grants for development of vaccines or drugs to treat rare diseases.

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[31] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 283; H.Rep. 99-426, p. 230; Senate floor amendment, 132 Cong. Rec. S 7793 (June 18, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 77 (Conference Report).

Explanation of Provision

The Act extends the orphan drug credit for three additional years (i.e., through December 31, 1990).[32]

Effective Date

The provision is effective on the date of enactment (October 22, 1986).

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $7 million in 1988, $15 million in 1989, $15 million in 1990, and $8 million in 1991.

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[32] See also sec. 1879(b) of the Act, making certain changes to the definition of rare disease or condition in Code sec. 28(d)(1).

D. Rapid Amortization Provisions

1. Trademark and trade name expenditures (sec. 241 of the Act and sec 177 of the Code)[33]

Prior Law

Prior law permitted taxpayers to elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which was part of the consideration for an existing trademark or trade name.

Reason for Change

The special amortization provision for trademark and trade name expenditures was enacted in 1956, in part because of a perception that certain large companies whose in-house legal staff handled trademark and trade name matters were able in some cases to deduct compensation with respect to these matters, because of difficulties of identification, while smaller companies that retained outside counsel were required to capitalize such expenses.[34] However, in reconsidering this provision, Congress did not believe that the possibility that some taxpayers may fail accurately to compute nondeductible expenses was a justification for permitting rapid amortization. Furthermore, to the extent such mischaracterization occurs, a five-year amortization provision only partially alleviates any unfairness. There is no basis for a presumption that a trademark or trade name will decline in value, or that investment in trademarks and trade names produces special social benefits that market forces might inadequately reflect. Congress believed that a tax incentive for trademark or trade name expenditures is therefore inappropriate.

Explanation of Provision

The Act repeals the election. Trademark and trade name expenditures must be capitalized and recovered on a disposition of the asset. No amortization or depreciation is allowed with respect to such expenditures.

Effective Date

The provision is generally effective for expenditures paid or incurred after December 31, 1986.

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[33] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 221; H.Rep. 99-426, pp. 171-172; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 634; S.Rep. 99-313, pp. 256-257; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 78 (Conference Report).

[34] See, S. Rep. 1941, 84th Cong. 2d Sess., pp. 8-9 (1956).

However, prior law applies to expenditures incurred: (1) pursuant to a written contract that was binding as of March 1, 1986; or (2) with respect to development, protection, expansion, registration or defense of trademarks or trade names commenced as of March 1, 1986, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date, provided in each case the trademark or trade name is placed in service before January 1, 1988.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $4 million in 1987, $13 million in 1988, $25 million in 1989, $41 million in 1990, and $58 million in 1991.

2. Qualified railroad grading and tunnel bores (sec. 242 of the Act and sec. 185 of the Code)[35]

Prior Law

Under prior law, domestic railroad common carriers could elect to amortize the cost of qualified railroad grading and tunnel bores over a 50 year period. "Qualified railroad grading and tunnel bores" included all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed of right-of-way for railroad track.

Reason for Change

The special amortization provision for railroad grading and tunnel bore expenditures were enacted in 1969 to encourage investment in light of uncertainties about the useful life of such property. The scope of the provision was extended in 1976, to cover expenditures for pre-1969 property. However, Congress believed that continuation of the benefit is inconsistent with tax reform.

Explanation of Provision

The election is repealed. No amortization or depreciation deduction for railroad grading and tunnel bores will be allowed.

In addition, special ACRS treatment is provided for a particular railroad disaster and involuntary conversion treatment of insurance proceeds in that case is specified.

The repeal of the election generally applies to expenses paid or incurred on or after January 1, 1987. However, prior law continues to apply to expenditures incurred: (1) pursuant to a written contract that was binding as of March 1, 1986; or (2) with respect to construction, reconstruction, alteration, improvement, replacement or restoration commenced as of March 1, 1986, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date, provided in each case the improvements are placed in service before January 1, 1988.

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[35] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 224; H.Rep. 99-426, pp. 174-5; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 202(g); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 79-80 (Conference Report).

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by less than $5 million in each of the years 1987 through 1991.

3. Bus operating authorities; freight forwarders (sec. 243 of the Act and section 266 of the Economic Recovery Tax Act of 1981)[36]

Prior Law

Prior to enactment of the Bus Regulatory Reform Act of 1982, intercity bus operators were required to obtain an operating authority from the Interstate Commerce Commission (ICC) before providing service on a particular route. Because the ICC issued only a limited number of bus operating authorities, persons wishing to enter a route often purchased an existing bus company with the desired operating authority, paying substantial amounts for these operating authorities. Thus, the value of bus operating rights constituted a substantial part of a bus operator's assets and a source of loan collateral.

The 1982 statute greatly eased entry into the intercity bus industry. Because of this, the value of bus operating authorities diminished significantly, to the point where they are now essentially worthless.

A deduction is allowed for any loss incurred in a trade or business during the taxable year, if the loss is not compensated for by insurance or otherwise (Code sec 165(a)). In general, the amount of the deduction equals the adjusted basis of the property giving rise to the loss (sec. 165(b)). Treasury regulations provide that, to be deductible, a loss must be evidenced by a closed and completed transaction (i.e., must be "realized"), and must be fixed by an identifiable event (Treas. Reg. sec. 1.165-1(b)).

As a general rule, no deduction is allowed for a decline in value of property absent a sale, abandonment, or other disposition. Thus, for a loss to be allowed as a deduction, generally the business must be discontinued or the property must be abandoned (Treas. Reg. sec. 1.165-2)). Further, if the property is a capital asset and is sold or exchanged at a loss, the deduction of the resulting capital loss is subject to limitations (secs. 1212, 1211, and 165(f)).

The courts have denied a loss deduction where the value of an operating permit or license decreased as the result of legislation expanding the number of licenses or permits that could be issued. In the view of several courts,[37] the diminution in the value of a license or permit would not constitute an event giving rise to a deductible loss if the license or permit continues to have value as a right to carry on a business.

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[36] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 635; S.Rep. 99-313, pp. 257-9; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 80 (Conference Report).

[37] *See, e.g., Consolidated Freight Lines, Inc.* v. *Comm'r*, 37 B.T.A. 576 (1938), *aff'd*, 101 F.2d 813 (9th Cir.), *cert. denied*, 308 U.S. 562 (1939) (denial of loss deduction attributable to loss of monopoly due to State deregulation of the interstate motor carrier industry); *Monroe W. Beatty*, 46 T.C. 835 (1966) (no deduction allowed for diminution in value of liquor license resulting from change in State law limiting grant of such licenses).

Reasons for Change

The owners of bus operating authorities face a situation similar to that faced by owners of trucking company operating authorities after enactment of the Motor Carrier Act of 1980. That statute deregulated the trucking industry; as a result, motor carrier operating authorities lost significant value. In the Economic Recovery Tax Act of 1981, the Congress enacted a provision allowing trucking companies an ordinary deduction ratably over five years for loss in value of motor carrier operating authorities (sec. 166 of the 1981 Act).

Explanation of Provision

The Act allows an ordinary deduction ratably over a 60-month period for taxpayers who held one or more bus operating authorities on November 19, 1982 (the date of enactment of the Bus Regulatory Reform Act of 1982). The amount of the deduction is the aggregate adjusted bases of all bus operating authorities that were held by the taxpayer on November 19, 1982, or acquired after that date under a contract that was binding on that date.

The Act provides a similar rule for surface freight forwarders that were deregulated pursuant to the Surface Freight Forwarder Deregulation Act of 1986.

The 60-month period for bus operating authorities begins on November 1, 1982, or, at the taxpayer's election, the first month of the taxpayer's first taxable year beginning after that date. The Act requires that adjustments be made to the bases of authorities to reflect amounts allowable as deductions under the Act.

Under regulations to be prescribed by the Treasury, a taxpayer (whether corporate or noncorporate) holding an eligible bus operating authority would be able to elect to allocate to the authority a portion of the cost to the taxpayer of stock in an acquired corporation (unless an election under section 338 is in effect). The election would be available if the bus operating authority was held (directly or indirectly) by the taxpayer at the time its stock was acquired. In such a case, a portion of the stock basis would be allocated to the authority only if the corporate or noncorporate taxpayer would have been able to make such an allocation had the authority been distributed in a liquidation to which prior-law section 334(b)(2) applied. The election would be available only if the stock was acquired on or before November 19, 1982 (or pursuant to a binding contract in effect on such date).

Effective Date

The provision for bus operating authorities is effective retroactively for taxable years ending after November 18, 1982. The Act extends the period of limitations for filing claims for refund or credit of any overpayment of tax resulting from this provision, if such claim is presented on or before the date that is one year after the date of enactment of the Act. In such a case, a claim for refund or credit may be made or allowed if filed on or before the date that is eighteen months after such date.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $20 million in 1987.

4. Removal of architectural and transportation barriers to the handicapped and elderly (sec. 244 of the Act and sec. 190 of the Code)[38]

Prior Law

Prior law allowed electing taxpayers to deduct currently up to $35,000 of qualifying capital expenditures for the removal of architectural and transportation barriers to the handicapped and elderly. This rule applied to expenses paid or incurred in order to make more accessible to and usable by the handicapped and elderly any facility or public transportation vehicle owned or leased by the taxpayer for use in a trade or business. The election was not available in taxable years beginning after December 31, 1985.

Reasons for Change

Congress believed it desirable to continue to encourage the removal of architectural and transportation barriers to the handicapped and elderly, inasmuch as the social benefits of such expenditures may not be fully taken into account in private calculations of benefits and costs.

Explanation of Provision

The Act reinstates on a permanent basis, effective for expenses incurred in taxable years beginning after 1985, the provision that allows the expensing of up to $35,000 of costs incurred in the removal of architectural and transportation barriers to the handicapped and elderly.

Effective Date

The provision, effective on October 22, 1986 (date of enactment of the Act) applies to expenses incurred in taxable years beginning after 1985.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $26 million in 1987, $18 million in 1988, $19 million in 1989, $20 million in 1990, and $21 million in 1991.

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[38] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 225; H.Rep. 99-426, p. 175; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1707; S.Rep. 99-313, p. 882; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 81 (Conference Report).

E. Real Estate Provisions

1. Tax credit for rehabilitation expenditures (sec. 251 of the Act and secs. 46(b), 48(g), and 48(q) of the Code)[39]

Prior Law

A three-tier investment tax credit was provided for qualified rehabilitation expenditures. The credit was 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures (including residential buildings). A certified historic structure was defined as a building (and its structural components) that is listed in the National Register of Historic Places, or is located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

The rehabilitation credit was available only if the taxpayer elected to use the straight-line method of cost recovery with respect to the rehabilitation expenditures. If the 15- or 20-percent investment credit was allowed for qualified rehabilitation expenditures, the basis of the property was reduced by the amount of credit earned (and the reduced basis was used to compute cost recovery deductions) (sec. 48(q)(1) and (3)). The basis was reduced by 50 percent of the 25-percent credit allowed for the rehabilitation of certified historic structures.

Qualified rehabilitation expenditures were eligible for the credit only if incurred in connection with a substantial rehabilitation that satisfied an external-walls requirement. The test of substantial rehabilitation generally was met if the qualified expenditures during a 24-month measuring period exceeded the greater of the adjusted basis of the building as of the first day of the 24-month period, or $5,000. (In phased rehabilitations, the 24-month measuring period was extended to 60 months.)

The external-walls requirement provided generally that at least 75 percent of the existing external walls of the building had to be retained in place as external walls in the rehabilitation process. An alternative test provided that the external-walls requirement was met if (1) at least 75 percent of the external walls were retained in place as either internal or external walls, (2) at least 50 percent of such walls were retained in place as external walls, and (3) at least 75 percent of the building's internal structural framework was retained in place.

In the case of rehabilitations of certified historic structures, certain additional rules applied. In particular, the Secretary of the Interior had to certify that the rehabilitation was consistent with the historic character of the building or the historic district in which the building was located. In fulfilling this statutory mandate, the Secretary of the Interior's Standards for Rehabilitation were applied. *See* 36 CFR Part 67.7 (March 12, 1984).

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[39] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 232; H. Rep. 99-426, pp. 185-190; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1412; S.Rep. 99-313, pp. 752-756; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 82-83 (Conference Report).

Qualified rehabilitation expenditures generally included any amounts properly chargeable to capital account of a building in connection with a rehabilitation, but did not include the following:

(1) the cost of acquiring a building or an interest in a building (such as a leasehold interest);

(2) the cost of facilities related to a building (such as a parking lot); and

(3) the cost of enlarging an existing building.

Lessees were entitled to the credit for qualified expenditures incurred by the lessee if, on the date the rehabilitation was completed, the remaining lease term (without regard to renewal periods) was at least as long as the applicable recovery period (generally 19 years; 15 years in the case of low-income housing). Under regulations prescribed by the Secretary of the Treasury, the substantial rehabilitation test for a lessee was generally applied by comparing the lessee's qualified rehabilitation expenditures to the lessor's adjusted basis in the building (i.e., the lessee stepped into the shoes of the lessor).

The rehabilitation credit was subject to recapture if the rehabilitated building was disposed of or otherwise ceased to be qualified investment credit property with respect to the taxpayer during the five years following the date the property was placed in service. If the Department of the Interior decertified a rehabilitation of a certified historic structure during the recapture period, the property ceased to be qualified investment credit property.

Reasons for Change

In 1981, the Congress restructured and increased the tax credit for rehabilitation expenditures. The Congress was concerned that the tax incentives provided to investments in new structures (e.g., accelerated cost recovery) would have the undesirable effect of reducing the relative attractiveness of the prior-law incentives to rehabilitate and modernize older structures, and might lead investors to neglect older structures and relocate their businesses.

The Congress concluded that the incentives granted to rehabilitations in 1981 remain justified. Such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investors' profit projections. A tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings.

The Congress also sought to focus the credit particularly on historic and certain older buildings, to insure that the credits accomplish their intended objectives of preserving such historic and older buildings. In addition, the Congress was concerned that the existing credit percentages would be too high in the context of the lower overall rates provided in the Act. For example, the 25-percent credit under prior law offset tax on 50 cents of income for every $1 of rehabilitation expenditures made by an individual taxpayer in the top 50-percent bracket. A credit of 14 percent would accomplish the same offset to income with a top bracket of 28 percent. Similarly reduced credits would reproduce the same offsets to income as the current 15-percent and 20-percent rehabilitation credits.

Explanation of Provision

Two-tier credit

The Act replaces the existing three-tier rehabilitation credit with a two-tier credit for qualified rehabilitation expenditures. The credit percentage is 20 percent for rehabilitations of certified historic structures and 10 percent for rehabilitations of buildings (other than certified historic structures) originally placed in service before 1936.

Retention of certain rules

As under prior law, the 10-percent credit for the rehabilitation of buildings that are not certified historic structures is limited to nonresidential buildings, but the 20-percent credit for rehabilitation of historic buildings is available for both residential and nonresidential buildings.

The prior law provisions that determine whether rehabilitation expenditures qualify for the credit were generally retained. In general, no changes were made regarding the substantial rehabilitation test, the specific types of expenditures that do not qualify for the credit, the provisions applicable to certified historic structures and tax-exempt use property, or the recapture rules.

No expenditure will be eligible for credit unless the taxpayer recovers the costs of the rehabilitation using the straight-line method of depreciation.Further, expenditures incurred by a lessee will not qualify for the credit unless the remaining lease term, on the date the rehabilitation is completed, is at least as long as the recovery period under ACRS (generally 27.5 years for residential real property or 31.5 years for nonresidential real property).

External-walls requirement

The external-walls requirement was significantly modified. The provision that requires 75 percent of the existing external walls to be retained in place as external walls was deleted and replaced by the alternative test provided by prior law that requires the retention in place of (1) at least 75 percent of the existing external walls (including at least 50 percent as external walls) as well as (2) at least 75 percent of the building's internal structural framework. Thus, unlike the situation that could occur under prior law, a building that is completely gutted cannot qualify for the rehabilitation credit under the Act. In general, a building's internal structural framework includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

Because the Secretary of the Interior's Standards for Rehabilitation insure that certified historic structures are properly rehabilitated, the external-walls requirement for such buildings was deleted to provide the Secretary of the Interior with appropriate flexibilty. Rehabilitations eligible for the 20-percent credit must continue to be true rehabilitations, however, and not substantially new construction. Therefore, the Secretary of the Interior is expected to continue generally to deny certification to rehabilitations if less than 75 percent of the external walls are retained in place.

Basis reduction

The Act deletes the limited exception that required a basis reduction for only 50 percent of the credit in the case of certified historic structures. Thus, a full basis adjustment is required for both the ten-percent and 20-percent rehabilitation credits.

Effective Date

The modifications to the rehabilitation credit are generally applicable to property placed in service after December 31, 1986.

A general transitional rule provides that the modifications to the rehabilitation credit (other than certain reductions in the credit percentage—see below) will not apply to property placed in service before January 1, 1994, if the property is placed in service (as rehabilitation property) as part of either a rehabilitation completed pursuant to a written contract that was binding (under applicable state law) on March 1, 1986. This rule also applies to a rehabilitation with respect to property (including any leasehold interest) that was acquired before March 2, 1986, or was acquired on or after such date pursuant to a written contract that was binding on March 1, 1986, if (1) parts 1 (if necessary) and 2 of the Historic Preservation Certification Application were filed with the Department of the Interior (or its designee) before March 2, 1986, or (2) the lesser of $1,000,000 or five percent of the cost of the rehabilitation (including only qualified rehabilitation expenditures) is incurred before March 2, 1986, or is required to be incurred pursuant to a written contract that was binding on March 1, 1986.[40]

If a taxpayer transfers his rights in property under rehabilitation or under a binding contract to another taxpayer, the modifications do not apply to the property in the hands of the transferee, as long as the property was not placed in service before the transfer by the transferor. For purposes of this rule, if by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of a partnership under section 708(b)(1(B), the partnership is to be treated as having transferred its rights in the property under rehabilitation or the binding contract to the new partnership.

If property that qualifies under a transitional rules is placed in service after December 31, 1986, the applicable credit percentages are reduced from 15 to ten, and 20 to 13, respectively. The credit percentage is not reduced for property that qualifies for the 25-percent credit.[41]

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[40] A technical correction may be necessary to clarify that—under this rule—the rehabilitation need not be completed pursuant to a written contract that was binding on March 1, 1986.

[41] Similarly, property that qualifies for the 25-percent credit under a transitional rule is not subject to the full basis adjustment requirement. A technical correction may be needed to accomplish this result.

Property that qualifies for transitional relief from the amendments relating to the rehabilitation tax credit is also excepted from the depreciation changes made by section 201 of the Act.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $43 million in 1987, $165 million in 1988, $581 million in 1989, $1,371 million in 1990, and $1,779 million in 1991.

2. Tax credit for low-income rental housing (sec. 252 of the Act and sec. 42 of the Code)[1]

Prior Law

No low-income rental housing tax credit was provided under prior law, but other tax incentives for low-income housing were available. These tax incentives consisted principally of special accelerated depreciation, five-year amortization of rehabilitation expenses, expensing of construction period interest and taxes, and tax-exempt bond financing for multifamily residential rental property.

Reasons for Change

Congress was concerned that the tax preferences for low-income rental housing available under prior law were not effective in providing affordable housing for low-income individuals. Congress believed a more efficient mechanism for encouraging the production of low-income rental housing could be provided through the low-income rental housing tax credit.

The primary tax preferences provided for low-income housing under prior law were tax-exempt bond financing, accelerated cost recovery deductions, five-year amortization of rehabilitation expenditures, and special deductions for construction period interest and taxes. These preferences operated in an uncoordinated manner, resulted in subsidies unrelated to the number of low-income individuals served, and failed to guarantee that affordable housing would be provided to the most needy low-income individuals.

A major shortcoming of the prior-law tax subsidies was that, beyond a minimum threshold requirement of low-income housing units that were required to be served, the degree of subsidy was not directly linked to the number of units serving low-income persons. As a result, there was no incentive to provide low-income units beyond the minimum required. Under the tax credit, however, the amount of the low-income housing tax credit which an owner may receive is directly related to the number of rental units made available to low-income individuals. By providing tax credits which are based on the number of units serving low-income persons, an incentive exists to provide a greater number of housing units for more low-income individuals.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1413; S.Rep. 99-313, pp. 757-768; Senate floor amendment, 132 Cong. Rec. S8146-8158 (June 23, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 85-103 (Conference Report).

Another weakness of the Federal tax subsidies available under prior law was that they were not targeted to persons of truly low-income. For example, a study by the General Accounting Office[2] (GAO) of tax-exempt bond financed residential rental projects found that above-average income renters could qualify under prior law as "low" or "moderate" income for two reasons. First, persons with incomes as high as 80 percent of area median income were eligible to occupy units reserved for low- and moderate-income tenants. This income ceiling was relatively high, particularly when compared with the median income of renters. Second, the Treasury Department did not require household incomes to be adjusted for family size until after 1985. Congress believed that the low-income housing tax credit (as well as tax-exempt bond financing for low-income housing, discussed in Title XIII) should be provided only for households with incomes not exceeding 50 percent or 60 percent of area median income. Congress further believed that these income limits should be adjusted for family size. These provisions better target affordable housing to those persons most in need of assistance.

Another shortcoming of the tax subsidies under prior law was that none limited the rents that could be charged to low-income individuals. The same GAO study found, for example, that while 96 percent of individuals with incomes over 80 percent of area median income (the prior-law ceiling on "low" or "moderate" income) paid rents of less than 30 percent of their income, only 37 percent of individuals with incomes below 80 percent of area median paid rents of less than 30 percent of their income. The low-income housing tax credit limits the rent that may be charged to a low-income tenant, and therefore ensures that the subsidized housing is affordable to low-income individuals. In return for providing housing at reduced rents, owners of rental housing receive a tax credit designed to compensate them for the rent reduction.

Congress believed that the low-income housing tax credit (and tax-exempt bonds, as retargeted) will more effectively serve both low-income individuals and owners willing to provide affordable low-income housing than the multiple, uncoordinated tax preferences for low-income housing under prior law.

Explanation of Provisions

Overview

The Act provides a tax credit that may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years. New construction and rehabilitation expenditures for low-income housing projects placed in service in 1987 are eligible for a maximum nine percent credit, paid annually for ten years. The acquisition cost of existing projects and the cost of newly constructed projects receiving other Federal subsidies placed in service in 1987 are eligible for a maximum four percent credit, also paid annually for ten years. For buildings placed in service after 1987, these credit percentages will be adjusted to maintain a present value of 70 percent and 30 percent for the two types of credits.

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[2] United States General Accounting Office, *Report to the Chairman, Joint Committee on Taxation, Rental Housing: Costs and Benefits of Financing with Tax-Exempt Bonds* (GAO/RCED-86-2), February 1986.

The credit amount is based on the qualified basis (defined below) of the housing units serving the low-income tenants. Low-income tenants for purposes of the low-income housing tax credit are defined as tenants having incomes equal to or less than either 50 percent or 60 percent of area median income, adjusted for family size. The qualifying income for a particular property depends on the minimum percentage of units that the owner elects to provide for low-income tenants. Rents that may be charged families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualifying as "low", also adjusted for family size.

To qualify for the credit, residential rental property must comply continuously with all requirements of the credit throughout a 15-year compliance period. A credit allocation from the appropriate State or local credit authority must be received by the owner of property eligible for the low-income housing tax credit, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the new private activity bond volume limitation. These provisions are further explained in the following sections.

Credit amount and credit period

The Act provides two separate credit amounts: (1) a 70-percent present value credit for qualified new construction and rehabilitation expenditures (in excess of specified minimum amounts per unit) that are not federally subsidized and (2) a 30-percent present value credit for other qualifying expenditures. Expenditures qualifying for the 30-percent present value credit consist of the cost of acquisition of an existing building (including certain rehabilitation expenditures which are incurred in connection with acquisition and which do not exceed prescribed minimum amounts), and federally subsidized new construction or rehabilitation expenditures.

A taxpayer's credit amount in any taxable year is computed by applying the appropriate credit percentage to the appropriate qualified basis amount in such year, as defined below.[3] Except as described below, both credits are claimed annually over a 10-year period.

The credit period is the 10-year period beginning with the taxable year in which the building is placed in service or, at the election of the taxpayer, the succeeding taxable year. The credit may not be claimed for a taxable year in which the building is not in compliance with all requirements of the credit.

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[3] Congress understood that in certain cases low-income rental housing tax credit projects would be owned indirectly through partnerships. Congress intended that Treasury Department regulations will include rules treating partnerships as if they were taxpayers where appropriate to carry out the objectives of the tax credit. Congress intended, for example, that the partnership be treated as the taxpayer for purposes of determining whether a building is new (sec. 42(i)(4)). Where a partner's interest changes during a taxable year, it is intended that each partner's distributive share of the tax credit be determined under general partnership allocation rules (*see* sec. 706), i.e., by the use of a method prescribed in Treasury Department regulations that takes into account the varying interests of the partners in the partnership during such taxable year.

Credit percentage

For buildings placed in service in 1987, the credit percentages are 9 percent annually over 10 years for the 70-percent present value credit, and 4 percent annually over 10 years for the 30-percent present value credit.

For buildings placed in service after 1987, these credit percentages are to be adjusted monthly by the Treasury Department to reflect the present values of 70 percent and 30 percent at the time the building is placed in service. Treasury's monthly adjustments of the credit percentages are to be determined on a discounted after-tax basis, based on the average of the annual applicable Federal rates (AFR) for mid-term and long-term obligations for the month the building is placed in service. The after-tax interest rate is to be computed as the product of (1) the average AFR and (2) .72 (one minus the maximum individual Federal income tax rate). The discounting formula assumes each credit is received on the last day of each year and that the present value is computed as of the last day of the first year. For example, if 72 percent of the average AFR for a given month were 5.85 percent, the 70-percent and 30-percent present value credit percentages for buildings placed in service in that month would be 8.92 percent and 3.82 percent. (For the 70-percent present value credit, this is derived as $.0892 = (.70)(.0585)/[1.0585-1/(1.0585)^9]$.) In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.[4]

For buildings originally placed in service after 1987, Congress intended that the taxpayer, with the consent of the housing credit agency, may irrevocably elect to use the credit percentage determined using the above method for the month in which the taxpayer receives a binding commitment for a credit allocation from the credit agency or, in the case of a tax-exempt bond financed project for which no allocation is required, the month in which the tax-exempt bonds are issued.[5]

The credit percentage for rehabilitation expenditures (in excess of a prescribed minimum amount) is determined when rehabilitation is completed and the rehabilitated property is placed in service, but no later than the end of the 24-month period for which such expenditures may be aggregated.[6] These rehabilitation expenditures are treated as a separate new building for purposes of the credit.

The credit percentage for rehabilitation expenditures that are incurred in connection with the acquisition of an existing building (and which do not exceed prescribed minimum amounts) is the same percentage as is used for the acquired building, i.e., the percentage determined when the acquired building is placed in service.

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[4] As discussed below, a credit percentage equal to two-thirds of the credit percentage for the initial qualified basis is applicable to additions to qualified basis.

[5] A technical amendment may be needed so that the statute reflects this intent and the intent of Congress that such an election would be binding on the taxpayer and all successors in interest.

[6] Congress intended that the election to determine the credit percentage at the time a binding commitment for a credit allocation is received, described above, also apply in the case of credits attributable to rehabilitation expenditures (in excess of a prescribed minimum amount). A technical amendment may be needed so that the statute reflects this intent.

Qualified basis

In general

The qualified basis amounts with respect to which the credit amount is computed are determined as the proportion of eligible basis in a qualified low-income building attributable to the low-income rental units. This proportion is the lesser of (1) the proportion of low-income units to all residential rental units or (2) the proportion of floor space of the low-income units to the floor space of all residential rental units. Generally, in these calculations, low-income units are those units presently occupied by qualifying tenants, whereas residential rental units are all housing units, whether or not presently occupied.

The qualified basis for each building is determined on the last day of each taxable year, beginning in the taxable year in which the building is placed in service or, if the taxpayer elects, the following taxable year.

Special rules for determining qualified basis

The Treasury Department may provide regulations for projects consisting of two or more buildings. Unless prescribed in regulations, the qualified basis of a project consisting of two or more buildings is determined separately for each building. Common facilities in such a project must be allocated in an appropriate manner to all buildings (whether existing or to be constructed) in the project.

The first year the credit is claimed, the allowable credit amount is determined using an averaging convention to reflect the number of months units comprising the qualified basis were occupied by low-income individuals during the year. For example, if half of the low-income units included in qualified basis were first occupied in October and the remaining half were occupied in December, a calendar year taxpayer would adjust the allowable first-year credit to reflect that these units were occupied on average only one-sixth of the year. To the extent there is such a reduction of the credit amount in the first year, an additional credit in the amount of such reduction is available in the eleventh taxable year. (This first-year adjustment does not affect the amount of qualified basis with respect to which the credit is claimed in subsequent years of the 10-year credit period.)

Additions to qualified basis

The qualified basis of a building may be increased subsequent to the initial determination only by reason of an increase in the number of low-income units or in the floor space of the low-income units (as opposed to by reason of increases in the eligible basis). Credits claimed on such additional qualified basis are determined using a credit percentage equal to two-thirds of the applicable credit percentage allowable for the initial qualified basis. As described below under the description of the State credit ceiling, an allocation of credit authority must be received for credits claimed on additions to qualified basis, in the same manner as for credits claimed on the initial qualified basis. Unlike credits claimed on the initial qualified basis, credits claimed on additions to qualified basis are allowable annually for the portion of the required 15-year compliance period remaining after eligibility for such credits arises, regardless of the year such additional qualified basis is determined. The additional qualified basis is determined by reference to the original adjusted basis (before deductions for depreciation) of the property.

The credit amount on the additional qualified basis is adjusted in the first year such additions are made using an averaging convention to reflect the number of months units comprising the additional qualified basis were occupied by low-income individuals during the year. Any reduction of the credit amount in the first year may not be claimed in a later year. (This first-year adjustment does not affect the amount of additional qualified basis with respect to which the credit is claimed in subsequent years of the compliance period.)

Eligible basis

Eligible basis consists of (1) the cost of new construction, (2) the cost of rehabilitation, or (3) the cost of acquisition of existing buildings acquired by purchase (including the cost of rehabilitation, if any, to such buildings incurred before the close of the first taxable year of the credit period which do not exceed a prescribed minimum amount). Only the adjusted basis of the depreciable property may be included in eligible basis.[7] The cost of land is not included in adjusted basis.

Generally, the eligible basis of a building is determined at the time the building is placed in service. For this purpose, rehabilitation expenditures (in excess of $2,000 per unit) are treated as placed in service at the close of the period for which rehabilitation expenditures are aggregated, not to exceed 24 months. In the case of rehabilitation expenditures incurred in connection with the acquisition of an existing building (and which do not exceed a prescribed minimum amount), the capital expenditures incurred through the end of the first year of the credit period may be included in eligible basis.

For purposes of the low-income housing credit, the term residential rental property generally has the same meaning as residential rental property within Code section 142(d).[8] Thus, residential rental property includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. Eligible basis may include the cost of such facilities and amenities (e.g., stoves, refrigerators, air conditioning units, etc.) only if the included amenities are comparable to the cost of the amenities in the low-income units. Additionally, the allocable cost of tenant facilities, such as swimming pools, other recreational facilities, and parking areas, may be included provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project. (*See generally*, Treas. Reg. sec. 1.103-8(b)(4)(iii).)

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[7] The adjusted basis is determined by taking into account the adjustments described in section 1016 (other than paragraphs (2) and (3) of sec. 1016(a), relating to depreciation deductions), including, for example, the basis adjustment provided in section 48(q) for any rehabilitation credits allowed under section 38.

[8] See, however, the discussion below on single room occupancy housing as property eligible for the low-income housing credit.

Except as described below, costs of the residential rental units in a building which are not low-income units may be included in eligible basis only if such units are not above the average quality standard of the low-income units. Similarly, rehabilitation expenditures may not be included in eligible basis if such expenditures improve any unit in the building beyond comparability with the low-income units. Units are of comparable quality if the construction or acquisition costs are comparable and if such units are provided in a similar proportion for both the low-income and other tenants. Congress intended that, at the election of the taxpayer, the cost of a unit which would otherwise be excluded from eligible basis may be included in eligible basis if (1) the excess cost of such unit over the average cost of the low-income units does not exceed 15 percent of the average cost of the low-income units and (2) the excess cost is excluded from eligible basis.[9]

Residential rental property may qualify for the credit even though a portion of the building in which the residential rental units are located is used for a commercial use. No portion of the cost of such nonresidential rental property included in a project may be included in eligible basis. Congress intended that the costs of such a mixed-use facility be allocated according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the nonresidential rental property and the residential rental units. (*See*, e.g., Prop. Treas. Reg. sec. 1.103-8(b)(4)(v).)

Certain rehabilitation expenditures.—The qualified basis attributable to rehabilitation expenditures, unless incurred in connection with the acquisition of an existing building, must equal at least $2,000 per low-income unit.[10] The $2,000 minimum is computed as an average based on all qualifying expenditures in the building, rather than on a unit-by-unit determination. Qualified basis is determined in the same fractional manner as for new construction or acquisition costs even if all rehabilitation expenditures are made only to low-income units. Rehabilitation expenditures may be included in eligible basis without a transfer of property. Rehabilitation expenditures may be aggregated only for such expenditures incurred during any 24-month period. Where rehabilitation is limited to a group of units, Treasury may provide regulations treating a group of units as a separate new building.

Where rehabilitation expenditures are paid or incurred by a person (or persons) and the taxpayer acquires the property attributable to such expenditures (or an interest therein) before such property is placed in service, the taxpayer will be treated as having paid or incurred the expenditures (*see* Treas. Reg. sec. 1.167(k)-1(b)(1) and (2)). The portion of the basis of the property not attributable to rehabilitation expenditures may not be included in the eligible basis relating to the rehabilitated property, but may be includable in the eligible basis relating to acquisition costs, as described below.

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[9] A technical amendment may be needed so that the statute reflects this intent.

[10] See, below, in the case of rehabilitation expenditures incurred in connection with the acquisition of an existing building that do not exceed the $2,000 per unit minimium.

Acquisition of existing buildings.—The cost of acquisition of an existing building may be included in eligible basis and any rehabilitation expenditures to such a building incurred before the close of the first year of the credit period may at the election of the taxpayer also be included in eligible basis, without a minimum rehabilitation requirement. These costs may be included in eligible basis, however, only if the building or a substantial improvement (a capital expenditure of 25 percent or more of the adjusted basis of the building to which five-year rapid amortization was elected or to which ACRS applied (as in effect before the enactment of this Act)) to the building has not been previously placed in service within 10 years and if the building (or rehabilitated property within the building) is not subject to the 15-year compliance period.

A building that is transferred in a transfer where the basis of the property in the hands of the new owner is determined in whole or part by the adjusted basis of the previous owner (for example, by a gift of property) is considered not to have been newly placed in service for purposes of the 10-year requirement.[11] Further, Congress intended that a building which has been acquired by a governmental unit or certain qualified 501(c)(3) or 501(c)(4) organizations would not be treated as placed in service by that governmental unit or organization for purposes of the 10-year requirement if the acquisition occurs more than 10 years from the date the building or a substantial improvement to the building has last been placed in service.[12] Congress also intended that a building acquired by foreclosure by taxpayers other than a governmental unit or 501(c)(3) organization would not be treated as newly placed in service by that taxpayer for purposes of the 10-year requirement if the foreclosure occurs more than 10 years from the date the building or a substantial improvement to the building has last been placed in service and the property is resold within a short period.[13] Any other transfer will begin a new 10-year period.

The Treasury Department may waive the 10-year requirement for any building substantially assisted, financed or operated under the HUD section 8, section 221(d)(3), or section 236 programs, or under the Farmers' Home Administration section 515 program when an assignment of the mortgage secured by property in the project to HUD or the Farmers Home Administration otherwise would occur or when a claim against a Federal mortgage insurance fund would occur.

Federal grants and other subsidies.—Eligible basis may not include in any taxable year the amount of any Federal grant, regardless of whether such grant is included in gross income. A Federal grant includes any grant funded in whole or in part by the Federal government, to the extent funded with Federal funds. Examples of grants which may not be included in eligible basis include grants funded by Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants.

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[11] Congress intended that inherited property not be treated as being newly placed in service for purposes of the 10-year requirement. A technical amendment may be needed so that the statute reflects this intent.

[12] A technical amendment may be needed so that the statute reflects this intent.

[13] A technical amendment may be needed so that the statute reflects this intent.

If any portion of the eligible basis attributable to new construction or to rehabilitation expenditures is financed with Federal subsidies, the qualified basis is eligible only for the 30-percent present value credit, unless such Federal subsidies are excluded from eligible basis. A Federal subsidy is defined as any obligation the interest on which is exempt from tax under section 103 or a direct or indirect Federal loan, if the interest rate on such loan is less than the applicable Federal rate. A Federal loan under the Farmers' Home Administration section 515 program is an example of such a Federal subsidy, as is a reduced interest rate loan attributable in part to Federal grant funds lent to a building owner.

The determination of whether rehabilitation expenditures are federally subsidized is made without regard to the source of financing for the construction or acquisition of the building to which the rehabilitation expenditures are made. For example, a Federal loan or tax-exempt bond financing that is continued or assumed upon purchase of existing housing is disregarded for purposes of the credit on rehabilitation expenditures. Congress intended that tax-exempt financing or a below market loan to provide construction financing for any building will not be treated as a Federal subsidy if such loan is repaid and any underlying obligation (e.g., tax-exempt bond) is redeemed before the building is placed in service.[14]

Minimum set-aside requirement for low-income individuals

In general

A residential rental project providing low-income housing qualifies for the credit only if (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income, as adjusted for family size.[15] (This requirement is referred to as the "minimum set-aside" requirement.)

A special set-aside may be elected for projects that satisfy a stricter requirement and that significantly restrict the rents on the low-income units relative to the other residential units in the building (the "deep-rent skewing" set-aside). Projects qualify for this rule only if, as part of the general set-aside requirement, 15 percent or more of all low-income units are occupied by individuals having incomes of 40 percent (rather than 50 percent or 60 percent) or less of area median income, and the average rent charged to tenants in the residential rental units which are not low-income units is at least 300 percent of the average rent charged to low-income tenants for comparable units. Under this special rule, a low-income tenant will continue to qualify as such, as long as the tenant's income does not exceed 170 percent of the qualifying income. Additionally, if a project to which this special set-aside requirement applies ceases to comply with the requirement because of increases in existing tenants' incomes, no penalties are imposed if each available low-income unit is rented to tenants having incomes of 40 percent or less of area median income, until the project is again in compliance.[16]

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[14] A technical amendment may be needed so that the statute reflects this intent.

[15] A special set-aside requirement providing that 25 percent or more of the units are occupied by individuals with incomes of 60 percent or less of area median income is provided for New York City (*see* sec. 142(d)(6)).

All units comprising the minimum set-aside in a project must be suitable for occupancy and used on a nontransient basis, and are subject to the limitation on gross rent charged to residents of set-aside units. (See the discussion of the gross rent limitation, below.)

The owner of each project must irrevocably elect the minimum set-aside requirement (including the deep-rent skewing set-aside described above) at the time the project is placed in service. In the case of a project consisting of a single building, the set-aside requirement must be met within 12 months of the date the building (or rehabilitated property) is placed in service, and complied with continuously thereafter for a period ending 15 years after the first day of the first taxable year in which the credit is claimed.

Special rules apply to projects consisting of multiple buildings placed in service on different dates. Unless prescribed by regulations, the initial building, within 12 months of being placed in service, must meet the set-aside requirement determined only by reference to those units in the initial building. When a second or subsequent building is placed in service, the project must meet the set-aside requirement with respect to the units in all buildings placed-in-service up to that time within 12 months of the date the second or subsequent building is placed in service.[17] The project must comply with this expanded requirement continuously thereafter for a period ending 15 years after the later of (1) the first day of the taxable year in which the expanded requirement is met or (2) if a credit is claimed with respect to the building, the first day of the taxable year in which the credit period begins with such building.[18] Subsequent buildings are subject to separate 15-year compliance periods. After the 15-year period has expired on an initial building, but while other buildings in the same project are still subject to the compliance period, the project must continue to meet the set-aside requirement determined by reference to all buildings in the project or, at the taxpayer's election, all buildings subject to the compliance period.

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[16] Congress intended that for projects electing this stricter set-aside requirement the definition of gross rent is that used generally for purposes of the low-income credit. A technical amendment may be needed so that the statute reflects this intent.

[17] Congress intended that if within 12 months of the date a first building is placed in service, (1) the first building does not meet the set-aside requirement with respect to the first building and (2) a second building is placed in service, then the project is a qualified low-income project if the set-aside requirement is satisfied with respect to both buildings within 12 months of the placed-in-service date of the first building. A technical amendment may be needed so that the statute reflects this intent. Congress intended that similar rules apply by Treasury Department regulations in the case of projects with more than two buildings.

[18] Until the expanded requirement is met, the set-aside requirements determined by reference to all previously existing buildings must be continuously satisfied.

Continuous compliance required

The determination of whether a tenant qualifies for purposes of the low-income set-aside is made on a continuing basis, both with regard to the tenant's income and the qualifying area income, rather than only on the date the tenant initially occupies the unit. An increase in a tenant's income may result, therefore, in a unit ceasing to qualify as occupied by a low-income person. However, a qualified low-income tenant is treated as continuing to be such notwithstanding *de minimis* increases in his or her income. Under this rule, a tenant qualifying when initially occupying a rental unit will be treated as continuing to have such an income provided his or her income does not increase to a level more than 40 percent in excess of the maximum qualifying income, adjusted for family size. If the tenant's income increases to a level more than 40 percent above the otherwise applicable ceiling (or if the tenant's family size decreases so that a lower maximum family income applies to the tenant) that tenant is no longer counted in determining whether the project satisfies the set-aside requirement.[19] No penalty is assessed in such an event, however, provided that each residential rental unit that becomes vacant (of comparable or smaller size to the units no longer satisfying the applicable income requirement) is rented to tenants satisfying the qualifying income until the project is again in compliance. (For a discussion of the rules for complying with the set-aside requirements, see the discussion of the compliance period and penalty for noncompliance, below.)

Vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by a qualified low-income individual for purposes of the set-aside requirement (as well as for determining qualified basis) provided reasonable attempts are made to rent the unit and no other units of comparable or smaller size in the project are rented to nonqualifying individuals (see the section "Compliance period and penalty for noncompliance," below).

In no case is a unit considered to be occupied by low-income individuals if all of the occupants of such unit are students (as determined under sec. 151(c)(4)), no one of whom is entitled to file a joint income tax return.

Adjustments for family size

As stated above, the Act requires that adjustments for family size be made in determining the incomes used to qualify tenants as having low income. In general, these adjustments are the same as the adjustments presently made under section 8 of the United States Housing Act of 1937. Thus, for a project which qualifies by setting aside 20 percent of the units for tenants having incomes of 50 percent or less of area median income, a family of four generally will be treated as meeting this standard if the family has an income of 50 percent or less of the area median income; a family of three having an income of 45 percent or less generally will qualify; a family of two having an income of 40 percent or less generally will qualify; and, a single individual having an income of 35 percent or less generally will qualify.

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[19] In the case of projects electing the deep-rent skewing set-aside, a tenant's income may increase to 70 percent more than the maximum qualifying income.

Congress was aware that, in certain cases, the use of section 8 guidelines may result in qualifying incomes below the amounts reflected by these percentages because of dollar ceilings that are applied under the section 8 program. Income limits may be adjusted by the Treasury Department for areas with unusually low family income or high housing costs relative to family income in a manner consistent with determinations of very low income families and area median gross income under section 8 to reflect the 50-percent and 60-percent income levels.

Gross rent limitation

The gross rent paid by families in units included in qualified basis may not exceed 30 percent of the applicable qualifying income, adjusted for family size. Gross rent includes the cost of any utilities, other than telephone. If any utilities are paid directly by the tenant, the maximum rent that may be paid by the tenant is to be reduced by a utility allowance prescribed by the Treasury Department, after taking into consideration the procedures for making such adjustments under section 8 of the United States Housing Act of 1937.

The gross rent limitation applies only to payments made directly by the tenant. Any rental assistance payments made on behalf of the tenant, such as through section 8 of the United States Housing Act of 1937 or any comparable Federal rental assistance, are not included in gross rent. Congress further intended that any comparable State or local government rental assistance not be included in gross rent.[20]

Low-income unit

A low-income unit includes any unit in a qualified low-income building if the individuals occupying such unit meet the income limitation elected for the project for purposes of the minimum set-aside requirement and if the unit meets the gross rent requirement, as well as meeting all other requirements applicable to units satisfying the minimum set-aside requirement.

Qualified low-income housing projects and qualified low-income buildings

A qualified low-income building is a building subject to the 15-year compliance period and which is part of a qualified low-income housing project.

A qualified low-income housing project is a project that meets the minimum set-aside requirement and other requirements with respect to the set-aside units at all times that buildings comprising the project are subject to the 15-year compliance period. A qualified low-income housing project includes a qualified low-income building containing residential rental units and other property that is functionally related and subordinate to the function of providing residential rental units. A project may include multiple buildings having similarly constructed housing units, provided the buildings are located on the same tract of land, are owned by the same person for Federal income tax purposes, and are financed pursuant to a common plan of financing.

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[20] A technical amendment may be needed so that the statute reflects this intent. Such an amendment was included in the versions of H. Con. Res. 395 which passed the House of Representatives and Senate in the 99th Congress.

Residential rental units must be for use by the general public and all of the units in a project must be used on a nontransient basis. Residential rental units are not for use by the general public, for example, if the units are provided only for members of a social organization or provided by an employer for its employees. Generally, a unit is considered to be used on a nontransient basis if the initial lease term is six months or greater. Additionally, no hospital, nursing home, sanitarium, lifecare facility, retirement home providing significant services other than housing, dormitory, or trailer park may be a qualified low-income project. Factory-made housing which is permanently fixed to real property may be a qualified low-income building (see Treas. Reg. sec. 6a.103A-2(d)(4)(i) on factory-made housing).

Unlike the requirements for units in projects financed with tax-exempt bonds, certain single room occupancy housing used on a nontransient basis may qualify for the credit, even though such housing may provide eating, cooking, and sanitation facilities on a shared basis. An example of housing that may qualify for the credit is a residential hotel used on a nontransient basis that is available to all members of the public.

Compliance period and penalty for noncompliance

Qualified residential rental projects must remain as rental property and must satisfy the minimum set-aside requirement, described above, throughout a prescribed compliance period. Low-income units comprising the qualified basis on which additional credits are based are required to comply continuously with all requirements in the same manner as units satisfying the minimum set-aside requirement. Units in addition to those meeting the minimum set-aside requirement on which a credit is allowable also must continuously comply with this requirement.

The Act defines the compliance period for any building as the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date. The minimum set-aside requirement must be met, in all cases, within 1 year of the date the building (or rehabilitated property) is placed in service.

Within 90 days of the end of the first taxable year for which the credit is claimed and annually for each taxable year thereafter during the compliance period, the taxpayer must certify to the Secretary that the project has continuously complied throughout the year with the set-aside requirement and report the dollar amount of the qualified basis of the building and the maximum applicable percentage and qualified basis permitted to be taken into account by the housing credit agency. Additionally, the certification must include the date (including the taxable year) in which the building was placed in service and any other information required by Treasury.[21]

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set-aside requirement or the gross rent requirement or other requirements with respect to the units comprising the set-aside) is recapture of the accelerated portion of the credit, with interest, for all prior years.

Generally, any change in ownership by a taxpayer of a building subject to the compliance period is also a recapture event. An exception is provided if the seller posts a bond with the Treasury Department (in an amount prescribed by Treasury) and provided it can reasonably be expected that such building will continue to be operated as a qualified low-income building for the remainder of the compliance period. For partnerships consisting of more than 35 individual taxpayers, at the partnership's election, no change in ownership will be deemed to occur provided within a 12-month period at least 50 percent (in value) of the original ownership is unchanged.[22]

In the year of a recapture event, no credit is allowable for the taxpayer subject to recapture. Additionally, the accelerated portion of credits paid in earlier years is recaptured with interest, from the date the recaptured amount was claimed, at the overpayment rate established under section 6621. The accelerated portion of the credit in any year is the amount of credits determined for the year, less the amount which would have been determined for the year if all credits had been allowed ratably over the 15-year compliance period (with no further discounting). Because credits on the initial qualified basis of a building are claimed ratably over a 10-year credit period rather than the 15-year compliance period, the amount of credit recaptured for noncompliance during the first 11 years is one-third of the credit determined for the year, plus interest. In the absence of additions to qualified basis and previous recapture events, the credits are recaptured in the following amounts (in addition to interest): one-third for violations after year 1 and before expiration of year 11; four-fifteenths for violations after year 11 but before expiration of year 12; three-fifteenths for violations after year 12 but before expiration of year 13; two-fifteenths for violations after year 13 but before expiration of year 14; and one-fifteenth for violations after year 14 but before expiration of year 15.

Because credits claimed on additions to qualified basis are paid ratably over the remainder of the compliance period (the credit percentage is two-thirds of the otherwise applicable percentage), there is no accelerated portion of credits attributable to additions to qualified basis and, therefore, no recapture of these amounts.

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[21] Congress intended that the penalty under sec. 6652(j) shall apply for failure to provide such information. A technical amendment may be needed so that the statute reflects this intent.

[22] Congress intended that the presence of corporate partners not disqualify the partnership from this special exception provided the partnership is at least 50 percent owned by at least 35 individual taxpayers. A technical amendment may be needed so that the statute reflects this intent.

The penalty for a decrease in the qualified basis of a building, while still remaining part of a qualified low-income project, is recapture of the credits with respect to the accelerated amount claimed for all previous years on the amount of the reduction in qualified basis.

Owners and operators of low-income housing projects on which a credit has been claimed must correct any noncompliance with the set-aside requirement or with a reduction in qualified basis within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. If any noncompliance is corrected within a reasonable period, there is no recapture. Congress did not intend, however, that tenants be evicted to return a project to compliance. Rather, Congress intended that each residential rental unit of comparable or smaller size that becomes vacant while a project is not in compliance must be rented to a tenant having a qualifying income before any units in the project are rented to tenants not so qualifying until the project again is in compliance. In general, therefore, the event that gives rise to the penalty for noncompliance (i.e., recapture or a reduction in the allowable credit) will be rental of a unit to other than a low-income tenant (on other than a temporary basis) during any period when the project does not comply with the set-aside requirement or with the qualified basis amounts on which the credit is computed (or would not qualify as a result of that rental).

An example of how the recapture provisions operate follows:

Example.— Assume credits are claimed for a project based on a qualified basis of 30 percent of the basis of the project being allocable to units occupied by individuals with incomes of 50 percent or less of area median income and, at a later date, a qualified basis of only 25 percent of the basis of the project is allocable to units occupied by individuals with incomes of 50 percent or less of median income due to vacancies filled by tenants with nonqualifying incomes. Because the minimum set-aside requirement is not violated, recapture occurs only on the accelerated portion of the credit amounts allocable to the 5-percent basis of the project no longer eligible for the credit.

If the maximum credit for which a project is eligible increases and subsequently decreases, a last-in, first-out rule is applied in determining which credits are recaptured. For example, consider a building that initially claimed a credit based on a qualified basis of 25 percent of the basis of the building allocable to units occupied by individuals with incomes of 50 percent or less of area median income, and in year 3 began receiving a credit based on an additional 10 percent of the basis of the building (i.e., a total of 35 percent). The credit amount on the additions to qualified basis is computed by reference to two-thirds of the credit percentage. If in year 5 only 30 percent of the basis of the building qualifies, there is no recapture of previous years' credits because there is no accelerated portion of the credit amounts attributable to the 5 percent of the additions to qualified basis claimed since year 3.

Congress intended that there be no recapture for *de minimis* changes in the qualified basis by reason of changes in the floor space fraction.[23] A reduction in qualified basis by reason of a casualty loss is not a recapture event provided such property is restored by reconstruction or replacement within a reasonable period.

State low-income housing credit authority limitation

Generally, any building eligible for the credit must receive an allocation of credit authority from the State or local credit agency in whose jurisdiction the qualifying low-income housing project is located. (An exception is provided for buildings financed with the proceeds of tax-exempt bonds that received an allocation pursuant to the new private activity bond volume limitation.) The aggregate amount of such credits allocated within the State is limited by the State annual low-income credit authority limitation. In all cases, credit allocations are counted against a State's annual credit authority limitation for the calendar year in which the credits are allocated. Congress intended that credits may be allocated only during the calendar year in which the building or rehabilitated property is placed in service, except in the case of (1) credits claimed on additions to qualified basis and (2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service.[24] Under this latter exception, for example, a building placed in service in 1987 may receive a binding commitment in 1987 to receive a credit allocation of a specified amount in 1989. In 1989 this amount is subtracted from the State credit authority limitation. The credit period and compliance period with respect to the building begin in the taxable year in which the building is placed in service or, by an irrevocable election of the taxpayer, the succeeding taxable year.

An election by the taxpayer to defer the start of the credit period for one year does not affect when the allocation must occur. (See also, the discussion below for credits claimed on additions to qualified basis). The credit amount allocated to a building applies for the year the allocation is made and for all future years of the compliance period.

Allowable credit authority

General rules.—The annual credit authority limitation for each State is equal to $1.25 for every individual who is a resident of the State (as determined by the most recent estimate of the State's population released by the Bureau of the Census before the beginning of the year to which the limitation applies). For purposes of the credit authority limitation, the District of Columbia and U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are treated as States.

Special set-aside for qualified nonprofit organizations.—A portion of each State's credit authority limitation is set aside for exclusive use by qualified nonprofit organizations. This set-aside is equal to $0.125 per resident of the State. This set-aside amount may not be changed by State action, either legislative or gubernatorial. In addition to the special set-aside, qualified nonprofit organization projects may be allocated any additional amount of a State's remaining credit authority.

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[23] A technical amendment may be needed so that the statute reflects this intent.

[24] A technical amendment may be needed so that the statute reflects this intent. Credits allocated pursuant to an earlier binding commitment are counted against the State's annual credit authority limitation in the calendar year of the allocation.

To qualify for allocations from this set-aside, an organization must be a section 501(c)(3) or 501(c)(4) organization, one of the exempt purposes of which includes the fostering of low-income housing, and the qualifying project with respect to which the credits are allocated must be one in which such organization materially participates (within the meaning of the passive loss rule). Among the operations in which the organization must be involved in on a regular, continuous, and substantial basis, in addition to the continuing operation of the project, is the development of the project.

Credits subject to the credit authority limitation

Generally, credits subject to the State credit authority limitation include any credits attributable to expenditures not financed with tax-exempt bonds subject to the new private activity bond volume limitation.

In the case of a building financed with the proceeds of tax-exempt bonds subject to the bond volume limitation (Code sec. 146), if 70 percent or more of the aggregate basis of the building and land on which the building is located is financed with such proceeds, no portion of the credits attributable to such building is subject to the credit authority limitation.

If less than 70 percent of the aggregate basis of the building and land on which the building is located is financed with tax-exempt bonds subject to the bond volume limitation, only credits attributable to those bond-financed expenditures are not subject to the credit authority limitation.

Allocation of credit authority limitation among the State and other qualified governmental units therein

In general.—Each State's credit authority limitation is allocated among the various governmental units within the State pursuant to three alternative procedures.

Under the first procedure, each State's credit authority limitation is allocated in its entirety to the State housing agency until either the governor or the legislature makes a different allocation. If more than one such agency exists, they are treated as one agency. In the absence of a qualified State agency, no allocation may occur until provided by either the governor or the legislature.

Under the second procedure, the governor of each State is provided authority to allocate the State's credit authority limitation among all of the governmental units and other issuing authorities. This authority and any allocation rules established by the governor terminate as of the effective date of any overriding State legislation.

Under the third procedure, the State legislature may enact a law providing for a different allocation than that provided under the first or second procedures. Under this authority, the State legislature may allocate all or any portion of the State limitation to any governmental unit or other issuing authority in the State.

Congress intended that any allocation procedure established by the governor or State legislature give balanced consideration to the low-income housing needs of the entire State.

Congress desired to clarify that gubernatorial proclamations issued before the date of enactment of the Act (October 22, 1986) or State legislation enacted before that date is recognized for purposes of allocating the credit authority limitations, provided that the proclamation or legislation refers to the low-income housing tax credit authority limitation.

Congress further intended that a State be permitted to allocate available credit authority to a local issuer until a specified date during each year (e.g., November 1) at which time the authority, if unused, may revert to the State for reallocation. Similarly, a State statute may provide discretionary authority to a public official (e.g., the governor) to allocate the State's credit authority limitation. Because the credit authority limitation is an annual amount, however, any authority that has not been used for credits issued before the end of the calendar year expires.

Special rule for constitutional home rule subdivisions.—The Act provides a special allocation rule for certain political subdivisions with home rule powers under a State constitution (Illinois). The home rule subdivisions to which the special allocation rule applies are those home rule subdivisions that are granted home rule powers by the beginning of the calendar year in which the credits are issued pursuant to a State constitution that was adopted in 1970 and became effective on July 1, 1971. In that State, a full portion of the State credit authority limitation is allocated to each home rule subdivision based upon the ratio that the population of that home rule subdivision bears to the population of the entire State. As is true of the other credit authority limitation determinations, this allocation is made using the most recent population estimate from the Bureau of the Census released before the beginning of the calendar year to which the credits relate. The amount so allocated to home rule subdivisions may not be altered by the power to provide a different allocation otherwise granted by the Act to the governor or the State legislature. However, a home rule subdivision may agree to a different allocation.

The portion of a State's credit authority limitation not allocated to constitutional home rule subdivisions then is allocated under essentially the same three procedures described in the previous section. Thus, under the first procedure, the remaining State credit authority limitation is allocated to the State housing agency. Under the second and third procedures described above, the governor or the State legislature may allocate the State limitation other than that allocated to home rule subdivisions to any governmental units (including home rule subdivisions).

For purposes of the rules on State action establishing allocation rules for the credit authority limitation, a mayor of a constitutional home rule subdivision is treated as a governor, and a city council is treated as a State legislature.

Constitutional home rule subdivisions are treated as States for purposes of the credit authority limitation set-aside for qualified nonprofit organizations. Pursuant to their general authority to alter credit allocation, described above, these subdivisions may agree with the State in which they are located to exchange authority to allocate credits for qualified nonprofit organizations for authority to allocate credits for other projects.

Allocation of set-aside amount for qualified nonprofit organizations.—As described above, a portion of each State's credit authority limitation is set aside exclusively for projects of qualified nonprofit organizations. Although the overall amount of credit authority set aside for these credits may not be reduced by any State action, a State may enact a statute determining which credit authorities in the State may allocate these credits and may allocate the entire set-aside amount to those authorities. Similarly, before any legislation, a governor may determine which authorities may allocate credits under the set-aside. The amount of the remaining credit authority limitation allocated to all other authorities must, of course, be adjusted to take into account any reallocation of the set-aside amount.

Determination of credit amount allocation

A building must receive low-income credit authority from the credit agency in whose jurisdiction the qualifying low-income building is located. The credit agency's remaining authority is reduced by the credit percentage multiplied by the amount of qualified basis granted by the credit agency for the building. The credit agency may grant a smaller credit percentage and a smaller qualified basis amount at the time the allocation is made than the maximum percentage and amount that would otherwise be allowed. Congress intended that the credit agencies reduce the maximum available credit percentage when the financing and rental assistance for a project from all sources is sufficient to provide the continuing operation of the qualifying low-income building without the maximum credit.

A credit agency's credit authority is reduced by the maximum amount of credit granted, whether or not the property ultimately is eligible for this maximum amount, and without regard to the averaging convention used in the first year of the credit period.

If a building is granted more credits than would be claimed in the first year of the credit period, without regard to the averaging convention, such amounts are not restored to the credit agency's authority. Such amounts may, however, be used in a later year by the owner of the building to the extent the credit determined with respect to the building is increased as a result of additions to qualified basis (but not beyond the amount allocated by the agency, and without regard to the reduced percentage applicable to such additions). (See also, the discussion on additions to qualified basis, above.)

Example 1.—Assume in calendar year 1987 a newly constructed building is placed in service and that the building's qualified basis, before consideration of the credit authority limitation, is determined to be $100,000 in that year. The credit agency may allocate any amount of qualified basis to the building, but the taxpayer may treat as his qualified basis only the lesser of (1) the qualified basis of the building, before consideration of the credit authority limitation, or (2) the qualified basis allocated to the building by the credit agency. If the credit agency allocated $100,000 of qualified basis and the maximum 9 percent credit percentage to the building, the agency's remaining 1987 credit authority would be reduced by $9,000.

Example 2.—Assume $120,000 in qualified basis and a credit percentage of 9 percent were initially authorized by a credit agency in 1987 for a qualified low-income building and that in 1987, the first year of the credit period, the building's qualified basis was $100,000. The credit agency's remaining 1987 credit authority is reduced by $10,800. If in year two of the credit period the qualified basis of the building increases by up to $20,000 due to an increase in the number of low-income units, additional credits may be claimed with respect to this addition to qualified basis without requiring additional credit authority from the credit agency. The credit percentage applicable to the additional qualified basis is two-thirds of the credit percentage applicable to the initial qualified basis. Credits on the additions to qualified basis may be claimed over the remainder of the compliance period.

If the qualified basis of a building is greater than the qualified basis allocated to it by the credit agency, credits may not be claimed on the excess portion unless additional low-income housing credits are allocated to the building by the credit agency. The credit authority of the credit agency is reduced for the calendar year of any such additional allocations.

Generally, no carryover authority for unused credit authority is permitted. A limited exception is provided for buildings placed in service in 1990, if expenditures of 10 percent or more of total project costs are incurred before January 1, 1989. Credit authority for such property may be carried over from the 1989 credit allocation for the credit agency. Congress intended that, for allocations made after 1987, if a building cannot be placed in service in the year for which the allocation was made for reasons beyond the control of the taxpayer, then upon approval by the Treasury Department, the credit allocation will be valid if the building is placed in service in the succeeding year.[25]

Credit agencies are permitted to enter into binding commitments to allocate future credit authority for years before the sunset date to buildings not yet placed in service by binding contracts or other means.

Should a credit agency issue more credits than its credit authority limitation provides, credits will be denied to those buildings last allocated credits until the credit authority limitation is not exceeded.

Credit administration

Credit agencies allocating credits may not condition allocation of credits to the source of financing for the qualifying low-income building. The Act authorizes the Treasury Department to prescribe regulations that may require credit recipients to pay a reasonable fee to cover administrative expenses of the credit agency. The fact that credits must be allocated on a building-by-building basis does not preclude a credit agency from charging a single fee for processing credits for a single project with multiple buildings or for multiple projects of a common taxpayer.

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[25] A technical amendment may be needed so that the statute reflects this intent.

Agencies allocating credits must file reports with the Treasury Department containing (1) the maximum applicable percentage and qualified basis of each building, (2) the fees, if any, charged to credit recipients, (3) the aggregate amount of credits issued, and (4) other information required by Treasury. The time and manner of filing such reports and other information required are to be specified by the Treasury Department.

Transferability

A new owner of a building during its 15-year compliance period is eligible to continue to receive the credit as if the new owner were the original owner, using the same qualified basis and credit percentages as used by the original owner. Rehabilitation expenditures on such property may qualify for a credit in the same manner as rehabilitation expenditures on other qualifying property. The accelerated portion of credits claimed in previous years will be recaptured upon a transfer, subject to the election of the original owner to post a bond. All dispositions of ownership interests in buildings are treated as transfers for purposes of recapture, except for a special rule for certain partnerships. (There is no election for the new owner to assume the recapture liability for prior year credits.)

At-risk limitation

Property with respect to which a low-income housing tax credit is claimed is subject to an at-risk limitation similar to the investment tax credit at-risk rules in the case of nonqualified nonrecourse financing. An exception is provided for lenders related to the buyer of the low-income housing property. Another exception provides that the general investment tax credit at-risk rule, limiting the amount of nonrecourse financing to 80 percent of the credit base of the property, does not apply in the case of the low-income housing tax credit.[26]

A further exception is provided for financing (including seller financing) not in excess of 60 percent of the basis of the property that is lent by 501(c)(3) and 501(c)(4) organizations whose exempt purpose includes fostering low-income housing. Further, if the rate of interest for any financing qualifying for this exception is below the applicable Federal rate at the time the financing is incurred, less 1 percentage point, then the qualified basis to which such financing relates shall be reduced to reflect the present value of the payments of principal and interest, using as the discount rate such applicable Federal rate. The credit is recaptured if the financing provided by such organizations is not repaid with interest by the end of the 15-year credit compliance period.

Coordination with other provisions

The credit is subject to the rules of the general business credit, including the maximum amount of income tax liability that may be reduced by a general business tax credit in any year. Unused credits for any taxable year may be carried back to each of the 3 preceding taxable years and then carried forward to each of the 15 following taxable years. Congress intended that no credits be carried back to taxable years ending prior to January 1, 1987.[27]

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[26] This exception was enacted in the Omnibus Budget Reconciliation Act of 1986, P.L. 99-509.

For purposes of the rules in the Act limiting passive loss deductions, the credit (but not losses) is treated as arising from rental real estate activities in which the taxpayer actively participates. Credits may be used to offset tax on up to $25,000 of nonpassive income, subject to a phaseout between $200,000 and $250,000 of adjusted gross income (disregarding passive losses).

The basis of property for purposes of depreciation is not reduced by the amount of low-income credits claimed.

Effective Date

The credit is effective for buildings placed in service after December 31, 1986, and before January 1, 1991, other than (1) property to which the depreciation rules of prior-law apply or (2) property with respect to which any investor is eligible for passive losses under the special transitional exception contained in section 502 of the Act. Congress further intended that no property to which the provision of prior law allowing five-year amortization of rehabilitation expenditures applies may be included in eligible basis.[28] As stated above, all buildings eligible for the credit must be placed in service before January 1, 1991.[29] A building placed in service in 1990 is eligible for the credit, however, only if expenditures of 10 percent or more of the reasonably expected cost of the building are incurred before January 1, 1989. Under a special rule, described above, credit authority for such property placed in service in 1990 may be carried over from the 1989 volume allocation for any credit agency.

Revenue Effect

The low-income rental housing tax credit is estimated to reduce fiscal year budget receipts by $67 million in 1987, $324 million in 1988, $705 million in 1989, $1,011 million in 1990, and $1,139 million in 1991.

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[27] A technical amendment may be needed so that the statute reflects this intent.

[28] A technical amendment may be needed so that the statute reflects this intent.

[29] The Act contains a general rule preventing the allocation of credit authority to buildings placed in service after 1990. Congress intended that tax-exempt bond-financed projects be treated in the same manner as other projects, and are not eligible for the credit if placed in service after 1990. A technical amendment may be needed so that the statute reflects this intent. Such an amendment was included in the versions of H. Con. Res. 395 which passed the House of Representatives and Senate in the 99th Congress.

F. Merchant Marine Capital Construction Fund (Sec. 261 of the Act and new sec. 7518 of the Code)[30]

Prior Law

The Merchant Marine Act of 1936

The Merchant Marine Act of 1936, as amended, provides federal income tax incentives for U.S. taxpayers who own or lease vessels operated in the foreign or domestic commerce of the United States or in U.S. fisheries; these provisions were not contained in the Internal Revenue Code of 1954.

In general, qualified taxpayers were entitled to deduct from income certain amounts deposited in a capital construction fund pursuant to an agreement with the Secretary of Transportation or, in the case of U.S. fisheries, the Secretary of Commerce. Earnings from the investment or reinvestment of amounts in a capital construction fund were excluded from income.

The tax treatment of a withdrawal from a capital construction fund depended on whether it was "qualified." A nonqualified withdrawal of previously deducted or excluded monies by a taxpayer from a fund generated income to the taxpayer. A qualified withdrawal did not generate income to the taxpayer. A qualified withdrawal was a withdrawal for the acquisition, construction, or reconstruction of a qualified vessel, or for the payment of principal on indebtedness incurred in connection with the acquisition, construction, or reconstruction of such a vessel. A qualified vessel was defined as a vessel (including barges and containers) constructed or reconstructed in the United States, documented under U.S. laws, and which is to be operated in the U.S., foreign, Great Lakes, or noncontiguous domestic trade, or in U.S. fisheries.

A nonqualified withdrawal of previously deducted or excluded monies from a fund generated income to the taxpayer. In addition, interest on the tax liability attributable to a nonqualified withdrawal was payable from the date of deposit.

Capital cost recovery

Because provision was made for the deduction (or exclusion) of certain amounts deposited in a capital construction fund and their tax-free withdrawal in the case of a qualified withdrawal, the amount of funds withdrawn reduced the tax basis of the qualified vessel. This provision was designed to prevent double deductions, which would occur if a taxpayer was permitted to take depreciation deductions for amounts the taxpayer had already deducted from—or never included in—income.

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[30] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 13; H.Rep. 99-426, pp. 190-195; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 104 (Conference Report).

Investment tax credit

In general, the amount of investment tax credit for eligible property was determined with reference to the basis. A taxpayer could compute the investment tax credit for a qualified vessel (i.e., one that was financed in whole or in part by qualified withdrawals from a capital construction fund) by including at least one-half of qualified withdrawals in basis.

Reasons for Change

The Congress concluded that the provision of tax benefits for U.S. shipping through the Capital Construction Fund mechanism is appropriate. Aid to U.S. shipping industries is necessary to assure an adequate supply of ships in the event of war. The Congress has adhered to a policy of providing tax incentives to the domestic shipping industry for many years, and there was a concern that the elimination of such incentives, coupled with reduced appropriations for maritime construction, could injure the industry.

The incentive under prior law may not have functioned properly as an incentive for U.S. shipbuilding. Consequently, the Congress determined that additional requirements should be imposed to insure that capital construction funds are used for the intended purpose. The Congress was also concerned about the ability of taxpayers to avoid taxation on nonqualified withdrawals by making such withdrawals in years for which there are net operating losses (or other tax attributes that reduce the tax attributable to the withdrawal).

The Congress became aware during its tax reform hearings that Treasury's proposal to terminate the Capital Construction Fund (CCF) could have a serious adverse impact on the financial reporting requirements of CCF holders. The Congress did not intend that the modifications to the CCF program be viewed as requiring any change in the financial statement presentation of income taxes by CCF holders. These taxpayers should be allowed to provide future financial statements necessary for ship financing on a basis consistent with that anticipated at the time these taxpayers entered into CCF agreements with the Federal government.

Explanation of Provision

In general

The Act coordinates the application of the Internal Revenue Code of 1986 with the capital construction fund program of the Merchant Marine Act of 1936, as amended. In addition, new requirements are imposed, relating to (1) the tax treatment of nonqualified withdrawals, (2) certain reports to be made by the Secretaries of Transportation and Commerce to the Secretary of the Treasury, and (3) a time limit on the amount of time monies can remain in a fund without being withdrawn for a qualified purpose.

For purposes of the definition of the term "qualified withdrawals," under new section 7518(e) (sec. 607(f) of the Merchant Marine Act, 1936), the phrase "acquisition, construction, or reconstruction of a qualified vessel" is to be interpreted as including acquisition through either purchase or lease of an agreement vessel for a period of five years or more. This interpretation parallels the structure of: (1) the scope of eligibility to establish a capital construction fund under section 607(a) of the Merchant Marine Act, 1936 (which permits deposits into a CCF fund by either an owner/lessor or the lesee of an eligible vessel, or both, subject to certain limitations), and (2) the scope of qualified withdrawals for vessel acquisition through either purchase (in the form of a downpayment toward the purchase price) or payment of long-term indebtedness on an agreement vessel. This interpretation is also consistent with current industry acquisition practices reflecting a long-term trend toward vessel acquisition through lease rather than purchase.

Inclusion in Internal Revenue Code

The tax provisions relating to capital construction funds are recodified as part of the Internal Revenue Code of 1986. For purposes of the Internal Revenue Code of 1986, defined terms shall have the meaning given such terms in the Merchant Marine Act of 1936, as amended, as in effect, on the date of enactment of the Act.

Tax treatment of nonqualified withdrawals

The maximum rate of tax (34 percent for corporations and 28 percent for individuals) is to be imposed on nonqualified withdrawals made after December 31, 1986; This penalty is in addition to interest payable from the date the amount withdrawn was reported.

If a taxpayer makes a nonqualified withdrawal out of a capital construction fund, the income tax payable by the taxpayer for the year of withdrawal is generally to be increased by such amount as is necessary to assure that the tax liability with respect to the nonqualified withdrawal is determined by reference to the top marginal tax rates applicable to ordinary income and capital gains. Special rules are provided to limit the application of this provision in cases where the taxpayer derived no tax benefit from depositing the funds.

Departmental reports to Treasury

The Secretary of Transportation and the Secretary of Commerce are required to make annual reports to the Secretary of the Treasury regarding the establishment, maintenance, and termination of capital construction funds. These reports will also include determinations of whether a fundholder has failed to fulfill a substantial obligation under a capital construction fund agreement. Under joint regulations, and after notice and opportunity for hearing, if the Secretary determines that a substantial obligation is not being fulfilled, he or she may treat the entire fund—or any portion thereof—as a nonqualified withdrawal.

25-year limit on deposits

The Act imposes a 25-year limit on the amount of time monies can remain in a fund without being withdrawn for a qualified purpose. This rule applies to all deposits, including those made before the general effective date. The 25-year period begins to run on the later of the date of deposit or January 1, 1987.

Monies that are not withdrawn after a 25-year period are treated as nonqualified withdrawals, according to the following schedule:

for the 26th year, the fundholder would be treated as having withdrawn 20 percent; for the 27th year, 40 percent; for the 28th year, 60 percent; for the 29th year, 80 percent, and for the 30th year, 100 percent. For purposes of this rule, if a taxpayer commits an amount to the construction or acquisition of identified vessels pursuant to a binding contract entered into before the close of a taxable year, the amount so committed is not treated as remaining in the fund.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $3 million in 1987, $5 million in 1988, $4 million in 1989, $4 million in 1990, and $4 million in 1991.

TITLE III—CAPITAL GAINS AND LOSSES

A. Individual Capital Gains and Losses (Secs. 301 and 302 of the Act and secs. 1(j) and 1202 of the Code) [1]

Prior Law

Individual and other noncorporate taxpayers could deduct from gross income 60 percent of the amount of any net capital gain for the taxable year, i.e., 60 percent of the excess of net long-term capital gain over net short-term capital loss. As a result, the highest tax rate applicable to a noncorporate taxpayer's net capital gain was 20 percent (the 50 percent maximum individual tax rate times the 40 percent of net capital gain included in adjusted gross income).

Capital losses of individuals were deductible in full against capital gains. In addition, a maximum of $3,000 of capital losses was deductible against ordinary income. However, only 50 percent of net long-term capital losses in excess of net short-term capital gains could be deducted from ordinary income. Excess losses could be carried forward to future years.

Reasons for Change

The Congress believed that as a result of the Act's reduction of individual tax rates on such forms of capital income as business profits, interest, dividends, and short-term capital gains, the need to provide a reduced rate for net capital gain is eliminated. This will result in a tremendous amount of simplification for many taxpayers since their tax will no longer depend upon the characterization of income as ordinary or capital gain. In addition, this will eliminate any requirement that capital assets be held by the taxpayer for any extended period of time in order to obtain favorable treatment. This will result in greater willingness to invest in assets that are freely traded (e.g., stocks) and make investment decisions more neutral.

The Congress believed that the top rate on individual capital gains should not exceed the maximum rates set forth in the Act, and therefore the Act provides that the maximum tax rate on capital gains will not exceed the top individual rate that the Act provides in the event that the top individual rate is increased by a subsequent public law (unless that law specifically increases the capital gains tax).

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 241; H.Rep. 99-426, pp. 196-197; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 401 and 402; S.Rep. 99-313, pp. 169-170; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 105-106 (Conference Report).

Explanation of Provision

The Act repeals the net capital gain deduction for individuals.[2]

The Act also provides that the tax imposed by section 1 on an individual, estate, or trust cannot exceed the sum of (1) a tax computed at the rates under section 1 on the greater of (a) the taxpayer's taxable income reduced by the amount of net capital gain or (b) the amount of the taxpayer's taxable income which is taxed at a rate below 28 percent; (2) a tax of 28 percent on the amount of the taxpayer's taxable income in excess of the amount determined under (1) above; and (3) any additional tax resulting from the gradual phaseout of the benefits of the 15 percent bracket and the personal exemptions. If for any taxable year beginning after 1987, the highest individual rates (under the tax rate schedules set forth in subsections (a), (b), (c), (d) or (e) of section 1) do not exceed 28 percent, then this limitation will have no application.

The maximum rate on long-term capital gain in 1987 is 28 percent.

Capital losses are allowed in full against capital gain as under prior law. Capital losses are also allowed against up to $3,000 of ordinary income and the excess of net long-term capital loss over net short-term capital gain is allowed in full for this purpose. As under prior law, capital losses may be carried forward.

The prior statutory structure for capital gains is retained in the Code to facilitate reinstatement of a long-term capital gains rate differential if there is a future tax rate increase.

Effective Date

This provision applies to taxable years beginning after December 31, 1986, regardless of whether the sale or other transaction giving rise to the gain occurred in a prior year. Thus, if long-term capital gain is properly taken into income under the taxpayer's method of accounting in taxable years beginning after December 31, 1986, it is subject to the repeal of the net capital gain deduction. For example, the repeal of the net capital gain deduction applies to long-term capital gains recognized on the installment method in taxable years beginning after December 31, 1986, without regard to when the sale was made. Gains recognized in taxable years beginning after December 31, 1986, with respect to installment sales made before January 1, 1987, are thus subject to the new provisions.

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[2] The Act includes a conforming amendment to Code section 170(e)(1)(B), relating to certain charitable contributions of property. Under prior law, the deduction for contributions by individuals of unrelated-use tangible personal property, or of any appreciated property donated to certain private nonoperating (grant-making) foundations, essentially was limited to the donor's basis in the property plus the excludable amount of any long-term capital gain which would have been realized if the property had been sold. (The deductible amount for such contributions by corporations also is limited.) In conformity to the repeal of the capital gains exclusion for individuals, the Act essentially limits the deductible amount of such contributions by individuals to the donor's basis in the property. (A related change is made to the deductible amount of such contributions by corporations.) No change is made to the reduction rule in section 170(e)(1)(A) for contributions of ordinary-income property or to the exception to the reduction rule in section 170(e)(5) for contributions of qualified appreciated stock to certain private foundations. Under the Act (as under prior law), the amount of charitable deduction allowable to an itemizer for a donation of stock to a public charity equals (for regular tax purposes) the full fair market value of the stock at the time of the donation if the donor has held the stock for the long-term capital gain holding period, or the donor's basis in the stock if the donor has not held the stock for the long-term capital gain holding period (Code section 170(e)).

In the case of a pass-through entity that is not itself liable for tax, the provision applies to gain properly taken into account by the partner or other taxable beneficial owner in such person's taxable years beginning after December 31, 1986. For example, in the case of a calendar year individual partner in a partnership that has a fiscal year ending January 31, 1987, the repeal of the net capital gain deduction would apply to such partner's share of gain resulting from a cash sale by the partnership during the partnership's fiscal year ending January 31, 1987, regardless of whether the sale occurred prior to, or on or after, January 1, 1987. Similarly, the new provision would apply to such partner's share of any gain properly taken into account by the partnership on the installment method during the partnership's fiscal year ending January 31, 1987, regardless of whether the installment sale occurred in an earlier partnership fiscal year.

Long-term capital loss properly taken into account in taxable years beginning after December 31, 1986 is likewise subject to the new provisions. For example, in the case of a calendar year individual taxpayer with no capital gain properly taken into account in 1987, a long-term capital loss carryover from an earlier taxable year is allowed in full as an offset to 1987 ordinary income, up to the $3,000 limit.

Revenue Effect

The revenue effect of this provision is included with the revenue effect for individual rate changes (title I, Part A).

B. Corporate Capital Gains (Sec. 311 of the Act and sec. 1201 of the Code)[3]

Prior Law

An alternative tax rate of 28 percent applied to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate was lower than the corporation's regular tax (sec. 1201). Corporate capital losses were deductible only against capital gain. Capital losses generally could be carried back 3 years and forward 5 years.

Reasons for Change

Under prior law, large corporations obtained preferential treatment of capital gains income (28 percent alternative rate compared to 46 percent regular rate). The Congress was of the view that corporate capital gain should not be taxed at preferential rates, in light of the overall reduction in rates. Thus, the Act taxes corporate capital gains at the regular corporate tax rates.

Explanation of Provision

The Act makes the alternative tax inapplicable to taxable years for which the new corporate tax rates are fully effective (i.e., taxable years beginning on or after July 1, 1987). Thus, corporate net capital gain for such years is taxed at regular corporate rates (i.e., generally a maximum 34 percent under the Act). In the event that the maximum rate under Code section 11 is increased by a subsequent public law, the Act provides that a 34% alternative rate will be applicable unless such law changes that rate.

For taxable years which include periods prior to the time the new rates are fully effective, the alternative tax rate on gain properly taken into account under the taxpayer's method of accounting after December 31, 1986 is 34 percent. The Act provides that for any taxable year beginning on or after January 1, 1987, and before July 1, 1987, the alternate rate applicable to the net capital gain will be 34 percent. For taxable years beginning in 1986 and ending in 1987, a 28 percent rate will apply to the lesser of: (1) the net capital gain for the taxable year or (2) the net capital gain that is included in income under the taxpayer's method of accounting before January 1, 1987; any remaining net capital gain will be taxed at 34 percent.

The Act does not change the capital loss provisions.

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[3] For legislative background of the provision, see: H.R. 3838 as reported by the House Committee on Ways and Means on December 7, 1985, secs. 301 and 302; H.Rep. 99-426, pp. 231-233; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 106-107 (Conference Report).

The Act also contains two special rules (applicable to all taxpayers, whether or not corporations) in conjunction with the repeal of the special capital gains rates. First, the Act provides that income from coal and domestic iron ore royalties (under sec. 631(c)) will be eligible for percentage depletion for any taxable year in which the maximum rate of tax on net capital gain is not less than the maximum rate on ordinary income. Second, the Act provides that any election to treat the cutting of timber as a disposition under section 631(a) made for a taxable year beginning before January 1, 1987, may be revoked on a one-time basis by the taxpayer without the permission of the Secretary of the Treasury. Any revocation of an election made in accordance with this provision will not be considered in determining whether a future election under section 631(a) by the taxpayer is allowed. If a taxpayer revokes an election without consent in accordance with this provision, and thereafter makes an election under section 631(a), any future revocations will require the permission of the Secretary of the Treasury.

Effective Date

The provision applies to taxable years beginning after December 31, 1986, regardless of whether the sale or other transaction giving rise to the gain occurred in a prior year. Thus, so long as gain is properly taken into income under the taxpayer's method of accounting in a taxable year beginning after December 31, 1986, it is subject to the provision. A transitional rule described above also applies the provision to taxable years beginning in 1986 and ending in 1987, in the case of gain properly taken into account under the taxpayer's method of accounting on or after January 1, 1987.[4]

The provision applies to long-term capital gains recognized on the installment method in periods subject to the new alternative tax rates, without regard to when the sale was made. Installment sale gains properly taken into account under the installment method after December 31, 1986 are thus subject to the new provisions without regard to whether the sale was made prior to that date or in a prior taxable year.

In the case of a pass-through entity that is not itself liable for tax, the provisions apply to gain properly taken into account by the partner or other taxable beneficial owner after December 31, 1986. For example, a calendar year corporate partner in a partnership that has a fiscal year ending January 31, 1987 would be subject to the new provision, and would have a 34 percent alternative tax rate, with respect to such partner's share of long-term capital gain resulting from a cash sale by the partnership during the partnership's fiscal year ending January 31, 1987, regardless of whether the sale occurred prior to, or on or after, January 1, 1987. Similarly, the new provision would apply to such partner's share of any long-term capital gain properly taken into account by the partnership on the installment method during the partnership's fiscal year ending January 31, 1987, regardless of whether the installment sale occurred in an earlier partnership fiscal year.

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[4] Congress intended the application of the alternative tax to long-term capital gain to depend solely on when gain is properly taken into income under the taxpayer's method of accounting. Thus, for example, the alternative tax rates applicable to a particular item of long-term capital gain under these provisions (28 percent or 34 percent, as the case may be) determines the alternative tax on such gain. However, in determining whether such alternative tax is less than the tax otherwise payable, the otherwise applicable rules of section 15 of the Code shall apply in determining the section 11 rates in the case of a corporate taxpayer whose taxable year includes but does not begin on July 1, 1987. (See Title VI, Part A).

Revenue Effect

The revenue effect of this provision is included with the revenue effect for the corporate rate changes (Title VI, Part A).

C. Incentive Stock Options (Sec. 321 of the Act and sec. 422A of the Code) [5]

Prior Law

Under present and prior law, an employee is not taxed on the grant or exercise of an incentive stock option, and the employee is generally taxed at capital gains rates when the stock received on the exercise of the option is sold. No deduction is taken by the employer when the option is granted or exercised.

Under prior law, in order to qualify as an incentive stock option, among other requirements, the options must have been exercisable in the order granted, and the employer could not grant the employee such options to acquire stock with a value of more than $100,000 (increased by certain carryover amounts) in any one year.

Reasons for Change

The Congress wished to eliminate certain restrictions on incentive stock options so that it will be easier for employers, particularly small and relatively new companies, to use the options as a means of attracting and motivating talented employees.

The rule requiring options to be exercisable only in the order granted can make incentive stock options unavailable to companies which have experienced a decline in stock prices.

The Congress believed that limiting the amount of incentive stock options an employer may grant to an employee in a year unnecessarily restricts the ability of smaller companies to offer a comprehensive compensation package which it may need to offer talented employees if it is to compete with larger, more established corporations for such employees.

Explanation of Provision

The Act repeals the requirement that incentive stock options must be exercisable in the order granted.

The Act also changes the $100,000 limit to provide that under the terms of the plan the aggregate fair market value (determined at the time the option is granted) of the stock with respect to which incentive stock options are exercisable for the first time by any individual during any calendar year may not exceed $100,000.

Effective Date

The provision applies to options granted after December 31, 1986.

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[5] For legislative background of the provision, see: H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 411; S.Rep. 99-313, p. 171; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 107 (Conference Report).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts for 1987 through 1991 by less than $5 million annually.

D. Tax Straddles (Sec. 331 of the Act and sec. 1092 of the Code)[6]

Prior Law

In general, if a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that can be deducted is limited to the excess of the loss over the unrecognized gain (if any) in offsetting positions (sec. 1092). An exception to the loss deferral rule applies to a straddle consisting of stock that is offset by a qualified covered call. For purposes of this exception, a call option is not treated as qualified if gain from the disposition of the underlying stock is included in gross income in a taxable year subsequent to the year in which the option is closed, and the stock is not held for more than 30 days following the date on which the option is closed. This rule is intended to prevent taxpayers from using covered call options to defer tax on income from unrelated transactions (by realizing a loss on the option in one year, and deferring realizing any gain on the related stock until the next year).

Reasons for Change

Under prior law, the exception to the loss deferral rule for qualified covered call options applies even where the straddle is used to defer tax on income from unrelated transactions. Such deferral may occur where gain from closing the option is included in gross income in a taxable year subsequent to the year in which the stock is disposed of at a loss. The Act amends the definition of a qualified covered call to exclude a covered call option in these circumstances.

Explanation of Provision

Under the Act, the qualified covered call exception to the loss deferral rule is denied to a taxpayer who fails to hold a covered call option for 30 days after the related stock is disposed of at a loss, where gain on the option is included in the subsequent year.

Effective Date

The provision applies to positions established after December 31, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $5 million in each of fiscal years 1987 through 1991.

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[6] For legislative background of the provision, see: H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 422; S.Rep. 99-313, pp. 172-173; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 108 (Conference Report).

TITLE IV—AGRICULTURE, NATURAL RESOURCES, AND ENERGY

A. Agriculture Provisions

1. Special expensing provisions: soil and water conservation; clearing land (secs. 401 and 402 of the Act and secs. 175 and 182 of the Code) [1]

Prior Law

Expenditures for soil and water conservation

Under prior (and present) law, a taxpayer may elect to deduct certain expenditures for the purpose of soil or water conservation that would otherwise be added to the taxpayer's basis in the land on which the conservation activities occur (Code section 175). This deduction is limited in any one year to 25 percent of the gross income derived by the taxpayer from farming. Any excess amount is carried forward to succeeding taxable years.

Under prior law, expenditures deductible under section 175 included amounts paid for grading, terracing, and contour furrowing, the construction of drainage ditches, irrigation ditches, dams and ponds, and the planting of wind breaks. Also, assessments levied by a soil or water conservation drainage district were deductible under this provision to the extent those expenditures would have constituted deductible expenditures if paid directly by the taxpayer. The cost of acquiring or constructing depreciable machinery and facilities, however, were not eligible for expensing under this provision. In the case of depreciable items such as irrigation pumps, concrete dams, or concrete ditches, the taxpayer was allowed to recover costs only through cost recovery allowances, and only if the taxpayer owned the asset.

Expenditures for clearing land

Under prior law, a taxpayer engaged in the business of farming could elect to deduct currently amounts paid or incurred during the taxable year to clear land for use in farming (section 182). For any taxable year, this deduction could not exceed the lesser of $5,000 or 25 percent of the taxable income derived from farming.

Reasons for Change

Congress was concerned that certain Federal income tax provisions might be affecting prudent farming decisions. In particular,

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 921-922; H. Rep. 99-426, pp. 649-651; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 701-702; S. Rep. 99-313, pp. 264-265; Senate floor amendment, 132 Cong. Rec. S7827 (June 18, 1986); and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 110-111 (Conference Report).

Congress was concerned that these provisions were contributing to an increase in acreage under production, which in turn encouraged the overproduction of agricultural commodities. Congress believed that to the extent possible, the tax code should be neutral with respect to these business decisions. To eliminate tax biases, therefore, Congress determined that certain of the special farming expensing provisions should be repealed or restricted.

Explanation of Provisions

Soil and water conservation expenditures

The Act limits the soil and water conservation expenditures that may be deducted currently to amounts incurred that, in addition to satisfying the requirements of prior law, are consistent with a conservation plan approved by the Soil Conservation Service (SCS) of the Department of Agriculture. If there is no SCS conservation plan for the area in which property to be improved is located, amounts incurred for improvements that are consistent with a plan of a State conservation agency are deemed to satisfy the Federal standards. Finally, the Act provides that expenditures for general earth moving, draining, and/or filling of wetlands, and for preparing land for installation and/or operation of a center pivot irrigation system may not be deducted under this provision.

Expenditures for clearing land

The Act repeals the provision of prior law that allowed expenditures for clearing land in preparation for farming to be deducted in the year paid or incurred. However, expenditures for routine brush clearing and other ordinary maintenance activities relating to property used in farming continue to be deductible currently, to the extent they constitute ordinary and necessary business expenses under sec. 162.

Effective Date

The amendment to the provision relating to soil and water conservation expenditures is effective for expenditures after December 31, 1986. The repeal of the provision relating to land clearing expenses is effective for expenditures after December 31, 1985.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $50 million in 1987, $37 million in 1988, $34 million in 1989, $33 million in 1990, and $32 million in 1991.

2. Dispositions of converted wetlands and highly erodible croplands (sec. 403 of the Act and new sec. 1257 of the Code)[2]

Prior Law

Under prior law, gain realized on the sale or other disposition of a capital asset was subject to tax at preferential rates. The term

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[2] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 923; H. Rep. 99-426, pp. 651-652; H.R.

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capital asset (under both prior and present law) does not include property used in a taxpayer's trade or business that is of a character subject to depreciation (sec. 1221(2)). However, gain from the sale of such property ("section 1231 assets") may be taxed on the same basis as gain from the sale of a capital asset if gains on all sales of section 1231 assets during a taxable year exceed losses on such sales.

If losses from the sale or exchange of section 1231 assets during a taxable year exceed the gains from such sales or exchanges, the net losses are treated as ordinary losses. Ordinary losses are deductible in full for tax purposes, while deductions for capital losses are subject to limitations.

Reasons for Change

Congress was concerned about the environmental impact of the conversion of the nation's wetlands and erodible lands to farming uses, and wished to discourage such conversions.

Explanation of Provision

Under the Act, any gain realized on the disposition of "converted wetland" or "highly erodible cropland" is treated as ordinary income, and any loss realized on the disposition of such property is treated as a long-term capital loss.[3] For this purpose, the term "converted wetland" means land that is converted wetland within the meaning of section 1201(4) of the Food Security Act of 1985 (16 U.S.C. 3801(4)), provided such land is held by the person who originally converted the wetland, a person who uses the land for farming at any time following the conversion, or by a person whose adjusted basis in the property is determined by reference to the basis of a person in whose hands the property was converted wetland.[4] In general, the Food Security Act defines converted wetland as land that has been drained or filled for the purpose of making the production of agricultural commodities possible, if the production would not have been possible but for such action.

The term "highly erodible cropland" means any highly erodible cropland as defined in section 1201(6) of the Food Security Act of 1985 (16 U.S.C. 3801(6)) that is used by the taxpayer at any time for farming purposes other than the grazing of animals. In general, highly erodible cropland is defined as land that (1) is classified by the Department of Agriculture as class IV, VI, VII, or VIII land under its land capability classification system, or (2) that would have an excessive average annual rate of erosion in relation to the soil loss tolerance level, as determined by the Secretary of the Agriculture.

3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 703; S. Rep. 99-313, pp. 266-267; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 111-112 (Conference Report).

[3] Since other provisions of the Act (*see* Title III) eliminated the preferential rates applicable to individual and corporate capital gains, after 1986 the principal effect of this provision on gains is to prevent a taxpayer from offsetting the gains against capital losses.

[4] Thus, land that has been converted could become eligible for section 1231 treatment in the hands of, for example, a subsequent purchaser or legatee, provided the purchaser or legatee has used the property only for nonfarming purposes.

Effective Date

The provision is effective for dispositions of converted wetland and highly erodible cropland first used for farming after March 1, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

3. Prepayments of farming expenses (sec. 404 of the Act and sec. 464 of the Code)[5]

Prior Law

In general

Under prior (and present) law, a taxpayer generally is allowed a deduction in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income (sec. 461). The two most common methods of accounting are the cash receipts and disbursements method and the accrual method. If the taxpayer's method of accounting does not clearly reflect income, however, the computation of taxable income must be made under the method which, in the opinion of the Internal Revenue Service, clearly reflects income (sec. 446(b)). Furthermore, the income tax regulations provide that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which paid by a taxpayer using the cash receipts and disbursements method of accounting, or in which incurred by a taxpayer using the accrual method of accounting (see Treas. Reg. sec. 1.461-1(a)(1) and (2).)

Prior law was unclear as to the proper timing of a deduction for prepaid expenses other than interest. No specific statutory provision expressly permitted expenses to be deducted in full when paid by a taxpayer using the cash receipts and disbursements method of accounting. Such deductions were prohibited, however, to the extent that they resulted in a material distortion of income.

Generally, the courts examined all the facts and circumstances in a particular case to determine whether allowing a full deduction for the prepayment would result in a material distortion of income. In determining whether an expenditure resulted in the creation of an asset having a useful life extending substantially beyond the end of the taxable year, the court in *Zaninovich* v. *Commissioner,* 616 F.2d 429 (9th Cir. 1980), adopted a "one-year" rule. Under this rule, prepayments generally could be deducted if they did not provide benefits extending beyond one year. Thus, under this decision, it might be possible for a calendar-year, cash-basis taxpayer making a lease payment attributable to the following year to claim a deduction in the year of the payment.

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[5] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 704; S.Rep. 99-313, pp. 267-270; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 114 (Conference Report).

Certain cash method tax shelters may not deduct expenses before the time when economic performance occurs (e.g., when the goods are delivered or services performed). An exception is provided where economic performance occurs within 90 days of the end of the taxable year (sec. 461(i)(2)).

Special rules applicable to farming syndicates

Under prior law, certain limitations were imposed on deductions in the case of farming syndicates. A farming syndicate could deduct amounts paid for feed, seed, fertilizer, or other similar farm supplies only in the year in which such items were actually used or consumed or, if later, in the year such amounts were otherwise allowable as a deduction. A farming syndicate was defined generally as a partnership or any other enterprise (other than a corporation which was not an S corporation) engaged in farming if (i) interests in the partnership or enterprise were offered for sale in any offering required to be registered with any Federal or State agency or (ii) if more than 35 percent of the losses during any period were allocable to limited partners or limited entrepreneurs (i.e., persons who did not actively participate in the management of the enterprise).

Reasons for Change

Many farming tax shelters had been established to defer taxation of nonfarming income by prepaying farming expenses allocable to the following and subsequent years. Such tax shelters distorted the measurement of taxable incomes of their investors and affected farming operations that were not established for tax reasons. Congress believed that, in order to avoid these distortions, limits should be placed on the deductibility of prepaid expenses of certain farming tax shelters that did not fall within the definition of a farming syndicate.

Congress understood, however, that because of the seasonal nature of farming, numerous everyday business expenses are prepaid. Accordingly, the Act applies the limitations only to the extent that more than 50 percent of the farming expenses (exclusive of prepaid supplies) for the year are prepaid. In addition, in order to assure that farmers with continuous year-round or full-time farming activities are not subject to the limitations, the Act provides exceptions where a farmer has more than 50 percent prepaid expenses because of unusual or extraordinary circumstances. Congress believed that these rules will limit the application of the new restrictions to cases where the abuse is serious. In addition, Congress believed that the new rules will not impose any significant additional accounting burden on farmers.

Explanation of Provision

Under the Act, in the case of farmers eligible to use the cash method of accounting, the deductibility of prepayments for feed, seed, fertilizer, or other farm supplies may be limited in the same manner as prepayments made by a farming syndicate were limited under prior law.[5a] In addition, certain costs incurred in producing poultry may be subject to capitalization and amortization under special rules. The limitations apply only to the extent prepayments for supplies (or poultry expenses) exceed 50 percent of the taxpayer's total deductible farming expenses. This excess amount may not be deducted any earlier than the taxable year of actual use or consumption of the supplies to which it relates.

For purposes of the 50-percent test, deductible farm expenses include the operating expenses of the farm, such as ordinary and necessary expenses within the meaning of section 162, interest and taxes paid, depreciation allowances on farm equipment, and other similar expenses.[6] However, payments for feed, seed, fertilizer, or other supplies are deductible farm expenses only to the extent they are not prepayments, i.e., the supplies are consumed in the year of payment.

The Act provides two exceptions to the provision.[7] First, the provision does not apply to an eligible farmer—a "farm-related taxpayer"–who fails to satisfy the 50-percent test due to a change in business operations directly attributable to extraordinary circumstances, including government crop diversion programs and circumstances described in Code section 464(d) (supplies on hand at the end of the taxable year due to fire, storm, or other casualty, disease, or drought). Second, the provision does not apply to farm-related taxpayers whose prepaid supplies do not exceed the 50-percent threshold applied by aggregating prepayments and expenses (other than prepayments) for the three preceding taxable years.

A farm-related taxpayer includes (1) any person whose principal residence is on a farm, (2) any person with a principal occupation of farming, and (3) any family member of persons described in (1) or (2). The exceptions apply only to farming activities attributable to the farm on which the residence is located, or to farms included in the "principal occupation" of farming activities.

Congress did not intend that farmers will be required generally to take year-end inventories of prepaid items as a result of this provisions of the Act.

In adopting these limitations, Congress did not intend to modify or supersede the general rule that prepaid expenses are not deductible if that deduction would result in a material distortion of income.

Effective Date

The provision applies to amounts paid or incurred after March 1, 1986, in taxable years beginning after that date.

[5a] Under the Act, farming syndicates (as defined under secs. 464 of prior law) are now required to use the accrual method of accounting. (*See*, new sec. 448.)

[6] Generally these are the expenses reported on Schedule F of the taxpayer's Federal income tax return. Farm expenses do not include costs that must be inventoried or capitalized, e.g., the purchase price of an animal purchased for subsequent resale.

[7] Prepaid expenses of taxpayers eligible for one of these exceptions may be deducted to the same extent as under prior law, without regard to the 50-percent limitation.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $14 million in 1987, $30 million in 1988, $10 million in 1989, $11 million in 1990, and $14 million in 1991.

4. Discharge of indebtedness income for certain farmers (sec. 405 of the Act and secs. 108 and 1017 of the Code)[8]

Prior Law

Under prior and present law, gross income is defined to include income from discharge of indebtedness (sec. 61). If a solvent taxpayer received income from discharge of trade or business indebtedness, prior law provided the taxpayer an election to exclude that income if the taxpayer's basis in depreciable property was reduced (secs. 108 and 1017). If the amount of the discharge of indebtedness income exceeded a solvent taxpayer's available basis, the taxpayer recognized income in an amount of the excess.

Under prior (and present) law, if an insolvent taxpayer receives income from discharge of indebtedness, the income is excluded (to the extent it does not exceed the amount of the taxpayer's insolvency).[9] The taxpayer's tax attributes must be reduced by the amount of the excluded income. Reduction is required in the following attributes (in the following order): net operating losses and carryovers, general business credit carryovers, capital loss carryovers, basis of property,[10] and foreign tax credit carryovers. An insolvent taxpayer may elect to reduce basis in depreciable property before reducing net operating losses or other attributes.

If the amount of the insolvent taxpayer's discharge of indebtedness income (not in excess of the amount of its insolvency) exceeds its available tax attributes, the excess is disregarded, i.e., is not includible in income.

Reasons for Change

Congress was aware of enacted and pending legislation intended to alleviate the credit crisis in the farming sector, and of potential tax problems that might undermine the effectiveness of this legislation. For example, programs providing Federal guarantees on limited amounts of farm indebtedness in exchange for a lender's agreement to reduce the total amount of a farmer's indebtedness when that farmer had a high debt-to-equity ratio (but was not insolvent) were under consideration. Congress was concerned that such farmers would recognize large amounts of discharge of indebtedness income as a result of these loan write-downs—forcing them to forfeit their farmland rather than participate in programs designed to enable them to continue in farming.

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[8] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 706; S.Rep. 99-313, pp. 271-272; Senate floor amendment, 132 Cong. Rec. S7827 (June 18, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 115-116 (Conference Report).

[9] The amount of a taxpayer's insolvency is the excess of its liabilities over the fair market value of its assets.

[10] The reduction in basis is limited to the excess of the aggregate bases of the taxpayer's property over the taxpayer's aggregate liabilities immediately after the discharge.

Explanation of Provision

Under the Act, certain solvent taxpayers realizing income from the discharge of certain farming-related indebtedness may reduce tax attributes, including basis in property, under rules similar to those applicable to insolvent taxpayers. The discharged indebtedness must have been incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a gross receipts test.[11] The gross receipts test is satisfied if the taxpayer's aggregate gross receipts from farming for the three years preceding the year of the discharge are 50 percent or more of his aggregate gross receipts from all sources for the same period.[12]

If a taxpayer elects to exclude income under this provision, the excluded amount must be applied to reduce tax attributes of the taxpayer in the following order: (1) net operating losses, (2) general business credits, (3) capital loss carryovers, (4) foreign tax credit carryovers, (5) basis in property other than land used or held for use in the trade or business of farming, and (6) basis in land used or held for use in the trade or business of farming.

The amount of the exclusion under this provision may not exceed the aggregate amount of the tax attributes of the taxpayer specified above. Accordingly, income must be recognized to the extent the amount of the discharged indebtedness exceeds his available attributes.[13]

Effective Date

The provision applies to discharge of indebtedness income realized after the April 9, 1986, in taxable years ending after that date.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by $9 million in 1987, $10 million in 1988, $8 million in 1989, $7 million in 1990, and $5 million in 1991.

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[11] As under prior law, discharges of nonrecourse "loans" made by the Commodity Credit Corporation in connection with governmental crop price support programs, or other similar transactions that in substance constitute a sale of a farm product, are not within the scope of section 108 and hence are ineligible for relief under this provision.

[12] A technical amendment may be necessary to clarify that this was the intended operation of the gross receipts test.

[13] A technical amendment may be necessary to conform the Congress' intent that the relief for solvent farmers be as described above.

B. Oil, Gas, Geothermal, and Hard Mineral Properties

1. Intangible drilling costs and mining exploration and development costs (sec. 411 of the Act and secs. 263, 291, 616, and 617 of the Code)[14]

Prior Law

Intangible drilling and development costs

General rules

Under prior and present law, intangible drilling and development costs ("IDCs") may either be deducted in the year paid or incurred ("expensed") or else may be capitalized and recovered through depletion or depreciation deductions (as appropriate), at the election of the operator. In general, IDCs include expenditures by the operator incident to and necessary for the drilling and the preparation of wells for the production of oil or gas (or geothermal energy), which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property. IDCs include amounts paid for labor, fuel, repairs, hauling, supplies, etc., to clear and drain the well site, construct an access road, and do such survey and geological work as is necessary to prepare for actual drilling. Other IDCs are paid or incurred by the property operator for the labor, etc., necessary to construct derricks, tanks, pipelines, and other physical structures necessary to drill the wells and prepare them for production. Finally, IDCs may be paid or accrued to drill, shoot, fracture, and clean the wells. IDCs also include amounts paid or accrued by the property operator for drilling or development work done by contractors under any form of contract.[15]

Only persons holding an operating interest in a property are entitled to deduct IDCs. This includes an operating or working interest in any tract or parcel of oil, gas, or geothermal property, either as a fee owner, or under a lease or any other form of contract granting working or operating rights. In general, the operating interest in an oil or gas property must bear the cost of developing and operating the property. The term operating interest does not include royalty interests or similar interests such as production payment rights or net profits interests.

If IDCs are capitalized, a separate election may be made to deduct currently IDCs paid or incurred with respect to nonproductive wells ("dry holes"), in the taxable year in which the dry hole is completed. Thus, a taxpayer has the option of capitalizing IDCs for productive wells while expensing those relating to dry holes.

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[14] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 251 and 262; H. Rep. 99-426, pp. 200-204, 213-215; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 715-716; S. Rep. 99-313, pp. 280-282; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 120-125 (Conference Report).

[15] *See*, Treas. Reg. sec. 1.612-4 (pertaining to oil and gas wells) and sec. 1.612-5 (pertaining to geothermal wells).

Treatment of foreign IDCs

Domestic and foreign IDCs generally were subject to the same tax rules under prior law.

Twenty-percent reduction for integrated producers

In the case of a corporation which is an "integrated oil company",[16] the allowable deduction with respect to IDCs that the taxpayer has elected to expense was reduced by 20 percent. The disallowed amount was required to be amortized over a 36-month period, starting with the month in which the costs were paid or incurred. Amounts paid or incurred with respect to non-productive wells (dry hole costs) remain fully deductible when the non-productive well is completed, under prior and present law.

Mining exploration and development costs

General rules

Under prior and present law, taxpayers may elect to expense exploration costs associated with hard mineral deposits (sec. 617). Taxpayers also may expense development costs associated with the preparation of a mine for production (sec. 616).

Mining exploration costs are expenditures for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other depletable mineral, which are paid or incurred by the taxpayer prior to the development of the mine or deposit. When the mine reaches the producing stage, adjusted exploration expenditures (but not development costs) either: (1) are included in income (i.e., recaptured) and recovered through cost depletion; or (2) at the election of the taxpayer, reduce depletion deductions with respect to the property. Adjusted exploration expenditures with respect to a property are expensed exploration costs attributable to the property, reduced by the excess of (a) percentage depletion which would have been allowed but for the deduction for expensed exploration costs,[17] over (b) cost depletion for the corresponding period. Exploration costs also are subject to recapture if the property is disposed of by a taxpayer after expensing these amounts (secs. 617(d)).

Development costs include expenses incurred for the development of a property after the existence of ores or other minerals in commercially marketable quantities has been determined. These costs typically include costs for construction of shafts and tunnels and, in some cases, costs for drilling and testing to obtain additional information for mining operations.

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[16] An integrated oil company, for purposes of this provision, is any producer that is not an independent producer (as defined for the purposes of percentage depletion (sec. 613A) and the crude oil windfall profit tax).

[17] Because percentage depletion deductions are limited to 50 percent of net income from the property, deductions which reduce net income (e.g., the deduction for expensed exploration costs) may reduce the value of percentage depletion to the taxpayer.

Treatment of foreign exploration costs

Foreign exploration costs could not be expensed under prior law to the extent that such expensing would cause the cumulative foreign and domestic exploration costs which had been expensed by the taxpayer, in the taxable year and in previous taxable years, to exceed $400,000. Exploration costs which had been expensed by persons transferring mineral properties to the taxpayer were also taken into account for this purpose.

Twenty-percent reduction for corporations

For corporations, 20 percent of exploration and development costs that the taxpayer had otherwise elected to expense were required to be capitalized and recovered using the schedule for 5-year accelerated cost recovery system ("ACRS") property (sec. 291). For deposits located in the United States, such expenses also qualified for the investment tax credit.

Reasons for Change

Domestic production of oil, gas, and other minerals is currently depressed and subject to serious international competition. Congress believed that the tax incentives provided for IDCs and mining expenses are appropriate only with respect to domestic exploration. Accordingly, the Act requires that IDCs and mining exploration and development costs incurred outside the United States be recovered using 10-year amortization, which is the normative recovery period for excess IDCs and mining exploration and development costs under the minimum tax, or (at the taxpayer's election) as part of the cost depletion basis.

The Act increases the reduction in expensible IDCs of integrated oil companies from 20 to 30 percent, and requires nonexpensed amounts to be recovered over a 5 year period. A similar change is made in the treatment of corporate mining expenses. These changes are consistent with the general philosophy of the Act in reducing corporate tax preferences, and provide consistency in the treatment of oil- and mining-related expenses. Congress believed that increasing the section 291 reduction, rather than (e.g.) denying expensing for specified types of IDCs or mining costs, would reduce the tax preference for these industries without unduly limiting the incentive for any particular production.

Explanation of Provision

Domestic costs.—Under the Act, 30 percent of domestic IDCs of integrated producers are to be amortized ratably over a 60-month period, beginning in the month the costs are paid or incurred (sec. 291). The remaining 70 percent of integrated producer IDCs, together with all domestic IDCs of other taxpayers, are eligible for expensing as under prior law. This provision does not affect the option to deduct dry hole costs in the year the dry hole is completed.

In addition, 30 percent of domestic mining development and exploration costs of corporations are to be amortized ratably over a 60 month period (under sec. 291). The remaining 70 percent, together with similar costs of noncorporate taxpayers, are eligible for expensing as under prior law.

Foreign costs.—Under the Act, IDCs and mining exploration and development costs incurred with respect to properties located outside the United States are recovered (1) over a 10-year straight-line amortization schedule, beginning in the year the costs are paid or incurred, or (2) at the taxpayer's election, by adding these costs to the basis for cost depletion.[18] No change is intended in the treatment of property subject to an allowance for depreciation (see Treas. Reg. secs. 1.612-4(b), 1.612-5(b), 1.616-1(b)(2) and 1.617-1(b)(2)).

For purposes of this provision, the United States includes the 50 states, the District of Columbia, and those continental shelf areas which are adjacent to United States territorial waters and over which the United States has exclusive rights with respect to the exploration and exploitation of natural resources (sec. 638(1)).

The section 291 reductions, discussed above, do not apply to costs covered by this provision. The provision does not affect the option to deduct dry well costs in the year the dry well is completed.

Effective Date

These provisions are effective for costs paid or incurred after December 31, 1986. A transitional rule is provided with respect to certain IDCs incurred in connection with North Sea oil, pursuant to a license interest acquired on or before December 31, 1985.

Revenue Effect

The provisions with respect to intangible drilling costs (including foreign and domestic costs) are estimated to increase fiscal year budget receipts by $70 million in 1987, $113 million in 1988, $119 million in 1989, $114 million in 1990, and $54 million in 1991.

The provisions with respect to mining exploration and development costs (including foreign and domestic costs) are estimated to increase fiscal year budget receipts by $23 million in 1987, $34 million in 1988, $28 million in 1989, $24 million in 1990, and $21 million in 1991.

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[18] The prior law rule limiting the expensing of foreign exploration costs where cumulative expensed exploration costs exceed $400,000 (sec. 617(h) of prior law) remains in effect for costs paid or incurred prior to the effective date.

2. Modification of percentage depletion rules

a. Denial of percentage depletion for lease bonuses and advance royalties (sec. 412(a) of the Act and secs. 613 and 613A of the Code)[19]

Prior Law

Depletable costs incurred with respect to an oil, gas, or geothermal property are recovered using cost or percentage depletion, whichever results in the higher deduction for the year in question. Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of units produced and sold from that property during the taxable year to the number of units as of the taxable year. Under percentage depletion, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted using percentage depletion may not exceed 50 percent of the net income from that property in that year (the "net-income limitation"). Additionally, the deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income.[20]

The Tax Reduction Act of 1975 repealed the percentage depletion allowance for oil and gas production, except with respect to limited quantities produced by independent producers and royalty owners. Effective January 1, 1984, the percentage depletion rate for oil and gas produced by independent producers and royalty owners declined to a permanent level of 15 percent, and the quantity of oil and gas eligible for percentage depletion was limited to 1,000 barrels per day.

Following the 1975 depletion amendments, disagreement arose whether lease bonuses, advance royalties, and other amounts paid in advance of actual production from an oil or gas property continued to be entitled to percentage depletion. In January, 1984, the Supreme Court held that a bonus or advance royalty paid to a lessor in a year in which no oil or gas is produced was subject to percentage depletion, notwithstanding the 1,000 barrel per day limitation contained in the 1975 legislation (*Commissioner v. Engle*, 464 U.S. 206 (1984)). The Court left open the possibility that the Treasury Department could promulgate regulations giving effect to the 1,000 barrel per day limitation in such cases.

In June, 1984, the IRS announced the manner for determining percentage depletion by recipients of bonuses and advance royalties. According to this announcement, a bonus or advance royalty was to be taken into account for depletion purposes in the same year that the payment was includible in income (i.e., generally the year received). Bonus or advance royalty payments were to be converted to barrel-equivalents based on the average price of oil or gas produced from the property during the taxable year (if no oil or gas was produced or sold from the property, based on representative market or field prices), with percentage depletion being allowed only for the equivalent of 1,000 barrels per day of oil production. No percentage depletion allowance was provided for in any year other than the year in which the bonus or advance royalty was includible in income (I.R. Ann. 84-59, IRB 1984-23, June 4, 1984).

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[19] For legislative background of the provision, see: H.R. 3838 as reported by the House Committee on Ways and Means on December 7, 1985, sec. 253; H. Rep. 99-426, pp. 204-208; and H. Rep. 99-841, Vol. II (September 18, 1986), p. 122 (Conference Report.)

[20] The 65-percent limitation, and the limitations imposed by the 1975 legislation (discussed below), do not apply to geothermal wells.

Reasons for Change

In retaining percentage depletion for oil and gas properties, Congress wished to provide an incentive only with respect to actual production. Accordingly, Congress decided to specify that no percentage depletion is available for lease bonuses, advance royalties, or other payments that are not directly related to the actual production from a property. This provision reverses the holding in *Commissioner v. Engle, supra*, which required that some form of percentage depletion be allowed for such payments.

Explanation of Provision

The Act provides that percentage depletion is not allowed for lease bonuses, advance royalties, or any other amount payable without regard to actual production from the property. This rule applies to oil, gas, and geothermal properties.

Effective Date

The provision applies to amounts received or accrued after August 16, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $20 million in 1987, $49 million in 1988, $45 million in 1989, $45 million in 1990, and $45 million in 1991.

b. Excess percentage depletion for coal and iron ore (sec. 412(b) of the Act and sec. 291 of the Code)[21]

Prior Law

Prior and present law allow percentage depletion for hard minerals at rates ranging from 5 to 22 percent of gross income from the property. The percentage depletion rate for coal is 10 percent; the rate for iron ore is 15 percent for domestic deposits and 14 percent for deposits located outside the United States. The amount deducted for any mineral may not exceed 50 percent of the net income from the property in any taxable year. Percentage depletion is computed without regard to the taxpayer's basis in the property.

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[21] For legislative background of the provision, see: H.R. 3838 as reported by the House Committee on Ways and Means on December 7, 1985, sec. 261; H. Rep. 99-426, pp. 211-213; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 125-126 (Conference Report).

Under prior law, for corporations only, the excess of percentage depletion for coal (including lignite) and iron ore over the adjusted basis of the property was reduced by 15 percent (sec. 291).

Reasons for Change

Excess percentage depletion for coal and iron ore was reduced by 15 percent under TEFRA, as part of a general cutback in corporate tax preferences. This reduction remained at 15 percent after 1984, when other section 291 cutbacks were increased to 20 percent. Congress decided to increase this reduction from 15 to 20 percent as part of the general policy of the Act in reducing corporate tax preferences.

Explanation of Provision

The Act increases the reduction in excess coal and iron ore percentage depletion for corporations (under section 291) from 15 to 20 percent.

Effective Date

The provision applies to taxable years beginning after December 31, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $11 million in 1987, $16 million in 1988, $15 million in 1989, $16 million in 1990, and $17 million in 1991.

3. Gain from disposition of interests in oil, gas, geothermal, or other mineral properties (sec. 413 of the Act and secs. 617 and 1254 of the Code)[22]

Prior Law

Under prior and present law, recapture rules characterize as ordinary income a portion of gain upon the disposition of assets when certain deductions previously have been allowed with respect to those assets. Under prior law, these recapture rules included the recapture of mining exploration (but not development) costs and intangible drilling costs, in excess of the amounts which would have been deductible as cost depletion if these items had been capitalized (secs. 617(d) and 1254).

Reasons for Change

Congress believed that if an amount has been allowed as an expense, and if upon the disposition of the asset with respect to which the deduction was allowed it is determined that the amount allowed exceeded the actual decline in value of the asset, capital gains treatment generally should be denied. This principle is applied to depreciation of personal property, and also should apply to depletable property.

Explanation of Provision

Under the Act, the prior law rules of section 1254 are expanded to apply not only to intangible drilling costs (IDCs) but also to depletion, to the extent the depletion deduction has reduced the adjusted basis of the property. Thus, upon the disposition of an oil, gas, or geothermal property, the amount of gain, if any, that is treated as ordinary income will include not only excess IDCs, but rather all IDCs and depletion (to the extent depletion has reduced adjusted basis) with respect to the property.[23]

The Act also provides the same rules for mining-related costs. Under these rules, all expensed mining exploration and development costs (to the extent not included in income upon reaching the producing stage), as well as depletion to the extent it has reduced adjusted basis, will be subject to recapture upon disposition of mining property.

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[22] For legislative background of the provision, see: H.R. 3838 as reported by the House Committee on Ways and Means on December 7, 1985, secs. 243 and 262; H. Rep. 99-426, pp. 198-199; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 123-124, 126 (Conference Report).

[23] While generally conforming capital gain tax rates to the tax rates on ordinary income, the Act retains provisions of prior law relating to the capital gain/ordinary income distinction. (*See* Title III, above.)

Effective Date

The provision applies to property placed in service by the taxpayer after December 31, 1986, except if acquired pursuant to a written contract binding on September 25, 1985, and at all times thereafter.[24]

Revenue Effect

The revenue effect of this provision is included in the estimates relating to intangible drilling costs and mining exploration and development costs (Part B.1., above).

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[24] Where a property is placed in service before January 1, 1987, by a corporation and the property is transferred after 1986 to a second corporation filing a consolidated return with the transferor corporation, a subsequent disposition by the second corporation in a year in which the two corporations continue to file a consolidated return will not be subject to the new provision, so long as any additional depletion available to the group by reason of a stepped-up basis results in a corresponding current recognition of ordinary income (e.g., as in a deferred intercompany sale under Treas. Reg. 1.1502-13). The subsequent disposition outside the group will remain subject to the recapture of certain expensed IDCs as provided under prior law.

C. Energy-Related Tax Credits and Other Incentives

1. Business energy tax credits (sec. 421 of the Act and sec. 46(b) of the Code)[25]

a. Extension of credits

Prior Law

The business energy investment tax credits were enacted in addition to the regular investment tax credit to provide an additional tax credit designated as an incentive to purchase specified property or equipment that would reduce current demand for scarce petroleum resources. Credits for certain energy property expired after 1982. Energy credits were available through 1985 for the following energy property at the following rates: solar—15 percent; geothermal—15 percent; wind—15 percent; ocean thermal—15 percent; biomass—10 percent; and small scale hydroelectric—11 percent.

Reasons for Change

Business energy investment tax credits were enacted in the Energy Tax Act of 1978 and the Crude Oil Windfall Profit Tax Act of 1980 in order to stimulate the development and business application of a broad variety of property which utilized or produced energy sources which were perceived to be alternatives to petroleum, natural gas, and their products. Generally, the methods and sources of producing or utilizing alternative forms of energy were well known but, because of price and other advantages of systems using fossil fuel, they were not experiencing widespread application. The energy tax credits were intended to increase demand for alternate energy sources, thus stimulating technological advances in the production of equipment to produce such fuels and in the design and operating efficiency of the property using a renewable energy source.

Even though the regular and energy investment tax credits generally are repealed as part of the process of broadening the income tax base and increasing the importance of economic and market variables in making investment decisions, Congress believes that it is desirable to retain energy tax credits for certain renewable energy source property in order to maintain an after-tax price differential between renewable and fossil fuel sources. The steep decline in 1986 in petroleum prices has eliminated the incentive to purchase or produce the equipment required to exploit renewable fuel sources. Without the offsetting stimulus from the tax credit to use or produce renewable fuels, the experience gained in the production and use of such fuels and the technological competence developed in their production during the past decade will dissipate and will not be readily available if a fossil fuel shortage recurs. The retained credits are extended through 1987 or 1988 at progressively reduced rates to permit renewable energy technologies to phase into the experience of operating in competitive markets.

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[25] For legislative background of this subtitle, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 271-275; H.Rep. 99-426, pp. 216-227; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 711-714; S. Rep. 99-313, pp. 274-279; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 128-133 (Conference Report).

Explanation of Provision

Congress extended the energy tax credit for solar energy property at 15 percent in 1986, 12 percent in 1987, and 10 percent in 1988.

The energy tax credit for geothermal energy property is extended at 15 percent in 1986 and 10 percent in 1987 and 1988.

Present law is not changed with respect to dual purpose solar or geothermal energy property. Congress, however, noted with respect to this matter that there are administrative issues which the Secretary of the Treasury should resolve under the regulatory authority provided in the Energy Tax Act of 1978 and in subsequent Acts that have provisions relating to energy tax credits.

The energy tax credit for biomass property is extended at 15 percent in 1986 and at 10 percent in 1987.

The energy tax credit for ocean thermal property is extended at 15 percent through 1988.

It was intended that the 50-percent basis adjustment which is required when an energy tax credit is allowed under section 48(q) would continue in effect for the business energy tax credits which are extended under the Act.[26]

b. Affirmative commitment rules

Prior Law

The expired 10-percent credit for certain alternative energy property continues to be available for long-term projects which meet rules requiring (1) completion of engineering studies and application for all required permits before 1983, (2) binding contracts for 50 percent of special project equipment before 1986, and (3) project completion before 1991.

Reasons for Change

The affirmative commitment rules are specially constructed transition rules to meet long gestation periods required for planning and constructing such projects as elaborate chemical production complexes. In addition, energy tax credits are subject to the same 50-percent basis reduction as is the regular investment tax credit. Therefore, Congress believes that the energy tax credits earned under the affirmative commitment rules should be treated in the same manner as regular investment tax credits for transition property.

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[26] A technical correction may be needed so that the statute reflects this intent.

Explanation of Provision

The Act provides that energy tax credits earned under the affirmative commitment rules are treated in the same manner as the regular investment tax credit for transition property, i.e., they are available with a basis adjustment of 100 percent of the credit amount. In addition, such transition property also may be subject to a 35-percent reduction of the regular investment credit. (See Title II., item A.2., above, repeal of the regular investment tax credit.)

Effective Date

The Act provides that the extended energy tax credits apply to property placed in service after December 31, 1985.

Modification of the affirmative commitment rules also applies after December 31, 1985.

2. Neat alcohol fuels (sec. 422 of the Act and sec. 404(b) of the Code[27]

Prior Law

A 9-cents-per-gallon exemption from the excise tax on special motor fuels is provided through 1992 for neat methanol and ethanol fuels which are not derived from petroleum or natural gas. A 4-1/2 cents exemption is provided if the fuels are derived from natural gas. Neat alcohol fuels are at least 85 percent methanol, ethanol, and other alcohol.

Gasohol, which is a mixture of gasoline and ethanol that contains at least 10 percent ethanol, is eligible for a 6-cents-per-gallon exemption from the excise tax on gasoline. In addition, an income tax credit of 60 cents per gallon of ethanol is allowed for ethanol used for blending with gasoline.

Explanation of Provision

The 9-cents-per-gallon exemption is reduced to 6 cents.

Effective Date

This provision applies to sales or use after December 31, 1986.

3. Taxicab fuels tax exemption (sec. 422 of the Act and sec. 6427(e) of the Code)[28]

Prior Law

A 4-cents-per-gallon partial exemption from the motor fuels excise taxes (9 cents for gasoline and special motor fuels and 15 cents for diesel fuel) was provided for fuels used in qualifying taxicabs through September 30, 1985. The exemption was effectuated through a credit or refund (without interest). Qualifying taxicabs must meet certain group-ride requirements.

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[27] See footnote 25 (above), under Business Energy Tax Credits, for legislative background.

[28] See footnote 25 (above), under Business Energy Tax Credits, for legislative background.

Reasons for Change

Congress believed that continuation of this credit helps to encourage efficient use of this form of motor transportation.

Explanation of Provision

The 4-cents-per-gallon partial exemption from motor fuels excise taxes for qualified taxicabs is extended through September 30, 1988.

Effective Date

This provision is effective as of October 1, 1985.

Revenue Effect of Items 1–3

The changes in energy tax credits and related energy incentives (items 1, 2 and 3) are estimated to decrease fiscal year budget receipts by $227 million in 1987 and $58 million in 1988, and to increase fiscal year budget receipts by $1 million in 1989, $13 million in 1990, and $9 million in 1991.

4. Duty on imported alcohol fuels (sec. 423 of the Act and general headnote 3(a) and item 901.50 of the Appendix of the Tariff Schedules of the United States) [29]

Prior Law

A 60-cents-per-gallon duty is imposed through 1992 on alcohol imported into the United States for use as a fuel.

Ethyl alcohol may enter the United States duty-free, if it is imported from a Caribbean Basin Initiative (CBI) country, under the terms of the Caribbean Basin Economic Recovery Act (CBERA).

Reasons for Change

Congress is concerned that the simple distillation process for dehydrating ethyl alcohol does not represent the type of economic activity that will increase employment and productivity in the Caribbean area in the way that was intended in the CBI program. Use of the process, instead, has become a tactic to circumvent the 60-cents-per-gallon duty and to thwart the intent of the U.S. customs laws.

Explanation of Provision

Under the Act, ethyl alcohol (or an ethyl alcohol mixture) may be admitted into the United States duty-free, if it is an indigenous product of a U.S. insular possession or CBI beneficiary country.

Ethyl alcohol (or ethyl alcohol mixture) may be treated as being an indigenous product of an insular possession or beneficiary country only if the ethyl alcohol (or a mixture) has been both dehydrated and produced by a process of full-scale fermentation within that insular possession or beneficiary country. Alternatively, ethyl alcohol (or a mixture) must have been dehydrated within that insular possession or beneficiary country from hydrous ethyl alcohol that includes hydrous ethyl alcohol which is wholly the product or manufacture of any insular possession or beneficiary country and which has a value not less than (1) 30 percent of the value of the ethyl alcohol or mixture, if entered during calendar year 1987, (2) 60 percent of the value of the ethyl alcohol or mixture, if entered during calendar year 1988, and (3) 75 percent of the value of the ethyl alcohol or mixture, if entered after December 31, 1988.

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[29] See footnote 25 (above), under Business Energy Tax Credits, for legislative background.

Transitional exemptions are provided during 1987 and 1988 for up to 20 million gallons per year each produced by certain azeotropic distillation facilities: (1) located in a CBI country or insular possession and in operation on January 1, 1986; or (2) the equipment for which was, on January 1, 1986, ready for shipment to and installation in a CBI country. An additional transitional exemption is provided during 1987 to a facility in the Virgin Islands that received authorization prior to May 1, 1986, to operate a full-scale fermentation facility.

In enacting this provision, Congress expresses its disapproval of rulings by the Customs Service that have found the mere dehydration of industrial-grade ethanol into fuel-grade ethanol to constitute a substantial transformation sufficient to qualify the dehydrated ethanol as a product of a CBI country or insular possession and therefore entitled to duty-free treatment. By discouraging such pass-through operations, the conferees seek to encourage meaningful economic investment in CBI countries and insular possessions.

Effective Date

The limitation on duty-free entry of ethyl alcohol that is not an indigenous product of an insular possession or a beneficiary country is effective beginning on January 1, 1987. The two subsequent increases in the indigenous product's minimum value requirement are effective, respectively, on January 1, 1988, and January 1, 1989.

Revenue Effect

The limitation on duty-free entry of ethyl alcohol is estimated to increase fiscal year budget receipts by less than $5 million each fiscal year.

TITLE V—TAX SHELTERS; INTEREST EXPENSE

A. Limitations on Losses and Credits from Passive Activities (secs. 501 and 502 of the Act and new sec. 469 of the Code)[1]

Prior Law

In general, no limitations were placed on the ability of a taxpayer to use deductions from a particular activity to offset income from other activities. Similarly, most tax credits could be used to offset tax attributable to income from any of the taxpayer's activities.

There were some exceptions to this general rule. For example, deductions for capital losses were limited to the extent that there were not offsetting capital gains.[2] For purposes of the alternative minimum tax applying to individuals, expensed intangible drilling costs could be used to reduce net oil and gas income to zero, but could not offset other income of the taxpayer. Foreign tax credits could be used to reduce tax on foreign source income, but not U.S. source income. Research and development credits could be used by individuals to reduce tax liability attributable to research and development activities, but not taxes attributable to other income of the taxpayer.

In the absence of more broadly applicable limitations on the use of deductions and credits from one activity to reduce tax liability attributable to other activities, taxpayers with substantial sources of positive income could eliminate or sharply reduce tax liability by using deductions and credits from other activities, frequently by investing in tax shelters. Tax shelters commonly offered the opportunity to reduce or avoid tax liability with respect to salary or other positive income, by making available deductions and credits, possibly exceeding real economic costs or losses currently borne by the taxpayer, in excess or in advance of income from the shelters.

Reasons for Change

Congress concluded that it had become increasingly clear that taxpayers were losing faith in the Federal income tax system. This loss of confidence resulted in large part from the interaction of two of the system's principal features: its high marginal rates (in 1986, 50 percent for a single individual with taxable income in excess of $88,270), and the opportunities it provided for taxpayers to offset income from one source with tax shelter deductions and credits from another.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1401; S.Rep. 99-313, pp. 713-746; Senate floor amendment, 132 Cong. Rec. S8146-8158 (June 23, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 137-150 (Conference Report).

[2] In the case of an individual, a net capital loss of up to $3,000 was deductible. Net capital losses of corporations generally were not deductible.

The increasing prevalence of tax shelters—even after the highest marginal rate for individuals was reduced in 1981 from 70 percent to 50 percent—was well documented. For example, a Treasury study[3] revealed that in 1983, out of 260,000 tax returns reporting "total positive income"[4] in excess of $250,000, 11 percent paid taxes equaling 5 percent or less of total positive income, and 21 percent paid taxes equaling 10 percent or less of total positive income. Similarly, in the case of tax returns reporting total positive income in excess of $1 million, 11 percent paid tax equaling less than 5 percent of total positive income, and 19 percent paid tax equaling less than 10 percent of total positive income.[5]

Congress determined that such patterns gave rise to a number of undesirable consequences, even aside from their effect in reducing Federal tax revenues. Extensive shelter activity contributed to public concerns that the tax system was unfair, and to the belief that tax is paid only by the naive and the unsophisticated. This, in turn, not only undermined compliance, but encouraged further expansion of the tax shelter market, in many cases diverting investment capital from productive activities to those principally or exclusively serving tax avoidance goals.

Congress concluded that the most important sources of support for the Federal income tax system were the average citizens who simply reported their income (typically consisting predominantly of items such as salaries, wages, pensions, interest, and dividends) and paid tax under the general rules. To the extent that these citizens felt that they were bearing a disproportionate burden with regard to the costs of government because of their unwillingness or inability to engage in tax-oriented investment activity, the tax system itself was threatened.

Under these circumstances, Congress determined that decisive action was needed to curb the expansion of tax sheltering and to restore to the tax system the degree of equity that was a necessary precondition to a beneficial and widely desired reduction in rates. So long as tax shelters were permitted to erode the Federal tax base, a low-rate system could provide neither sufficient revenues, nor sufficient progressivity, to satisfy the general public that tax liability bore a fair relationship to the ability to pay. In particular, a provision significantly limiting the use of tax shelter losses was viewed as unavoidable if substantial rate reductions were to be provided to high-income taxpayers without disproportionately reducing the share of total liability under the individual income tax borne by high-income taxpayers as a group.

Congress viewed the question of how to prevent harmful and excessive tax sheltering as not a simple one. One way to address the problem would have been to eliminate substantially all tax preferences in the Internal Revenue Code. For two reasons, however, this course was determined by Congress to be inappropriate.

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[3] Treasury Department, "Taxes Paid by High-Income Taxpayers and the Growth of Partnerships," reprinted in IRS *Statistics of Income Bulletin* (Fall 1985), beginning at page 55.

[4] Total positive income was defined as the sum of salary, interest, dividends, and income from profitable businesses and investments, as reported on tax returns.

[5] Other studies similarly reached the conclusion that tax shelters, by flowing through tax benefits to individuals with positive sources of income, permitted some taxpayers with sizeable economic incomes substantially to reduce their tax liabilities. *See* Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985.

First, while the Act reduces or eliminates some tax preference items that Congress decided did not provide social or economic benefits commensurate with their cost, there were many preferences that Congress concluded were socially or economically beneficial. It was determined that certain preferences were particularly beneficial when used primarily to advance the purposes upon which Congress relied in enacting them, rather than to avoid taxation of income from sources unrelated to the preferred activity.

Second, Congress viewed as prohibitively difficult, and perhaps impossible, the task of designing a tax system that measured income perfectly. For example, the statutory allowance for depreciation, even under the normative system used under the Act for alternative minimum tax purposes, reflects broad industry averages, as opposed to providing precise item-by-item measurements. Accordingly, taxpayers with assets that depreciate less rapidly than the average, or that appreciate over time (as may be the case with certain real estate), could engage in tax sheltering even under the minimum tax, in the absence of direct action regarding the tax shelter problem.

Even to the extent that rules for the accurate measurement of income could theoretically be devised, Congress concluded that such rules would involve undue complexity from the perspective of many taxpayers. For example, a system that required all taxpayers to use a theoretically pure accrual method of accounting (e.g., including unrealized appreciation, and allowing only the amount of depreciation actually incurred for each specific asset in each taxable year) would create serious difficulties in both compliance and administration.

However, Congress concluded that when the tax system permits simpler rules to be applied (e.g., generally not taxing unrealized gain, and allowing depreciation based on broad industry averages), opportunities for manipulation are created. Taxpayers may structure transactions specifically to take advantage of the situations in which the simpler rules lead to undermeasurement or deferral of income.

The question of what constituted a tax shelter that should be subject to limitations was viewed as closely related to the question of who Congress intends to benefit when it enacts tax preferences. For example, in providing preferential depreciation for real estate or favorable accounting rules for farming, it was not Congress's primary intent to permit outside investors to avoid tax liability with respect to their salaries by investing in limited partnership syndications. Rather, Congress intended to benefit and provide incentives to taxpayers active in the businesses to which the preferences were directed.

In some cases, the availability of tax preferences to nonparticipating investors was viewed as harmful to the industries that the preferences were intended to benefit. For example, in the case of farming, credits and favorable deductions often encouraged investments by wealthy individuals whose principal or only interest in farming was to receive an investment return, largely in the form of tax benefits to offset tax on positive sources of income. Since such investors often did not need a positive cash return from farming in order to profit from their investments, they had a substantial competitive advantage in relation to active farmers, who commonly were not in a position to use excess tax benefits to shelter unrelated income. This significantly contributed to the serious economic difficulties being experienced by many active farmers.

The availability of tax benefits to shelter positive sources of income also harmed the economy generally, by providing a non-economic return on capital for certain investments. This encouraged a flow of capital away from activities that provided a higher pre-tax economic return, thus retarding the growth of the sectors of the economy with the greatest potential for expansion.

Congress determined that, in order for tax preferences to function as intended, their benefit should be directed primarily to taxpayers with a substantial and *bona fide* involvement in the activities to which the preferences related. Congress also determined that it was appropriate to encourage nonparticipating investors to invest in particular activities, by permitting the use of preferences to reduce the rate of tax on income from those activities; however, such investors were viewed as not appropriately permitted to use tax benefits to shelter unrelated income.

Congress believed that there were several reasons why it was appropriate to examine the materiality of a taxpayer's participation in an activity in determining the extent to which such taxpayer should be permitted to use tax benefits from the activity. A taxpayer who materially participated in an activity was viewed as more likely than a passive investor to approach the activity with a significant nontax economic profit motive, and to form a sound judgment as to whether the activity had genuine economic significance and value.

A material participation standard identified an important distinction between different types of taxpayer activities. It was thought that, in general, the more passive investor seeks a return on capital invested, including returns in the form of reductions in the taxes owed on unrelated income, rather than an ongoing source of livelihood. A material participation standard reduced the importance, for such investors, of the tax-reduction features of an investment, and thus increased the importance of the economic features in an investor's decision about where to invest his funds.

Moreover, Congress concluded that restricting the use of losses from business activities in which the taxpayer did not materially participate against other sources of positive income (such as salary and portfolio income) would address a fundamental aspect of the tax shelter problem. Instances in which the tax system applies simple rules at the expense of economic accuracy encouraged the structuring of transactions to take advantage of the situations in which such rules gave rise to undermeasurement or deferral of income. Such transactions commonly were marketed to investors who did not intend to participate in the transactions, as devices for sheltering unrelated sources of positive income (e.g., salary and portfolio income). Accordingly, by creating a bar against the use of losses from business activities in which the taxpayer does not materially participate to offset positive income sources such as salary and portfolio income, Congress believed that it was possible significantly to reduce the tax shelter problem.

Further, in the case of a nonparticipating investor in a business activity, Congress determined that it was appropriate to treat losses of the activity as not realized by the investor prior to disposition of his interest in the activity. The effort to measure, on an annual basis, real economic losses from passive activities gave rise to distortions, particularly due to the nontaxation of unrealized appreciation and the mismatching of tax deductions and related economic income that could occur, especially where debt financing was used heavily. Only when a taxpayer disposes of his interest in an activity was it considered possible to determine whether a loss was sustained over the entire time that he held the interest.

The relationship to an activity of an investor who did not materially participate was viewed as comparable to the relationship of a shareholder to a corporation. So long as the investor retained an interest in the activity, any reduction in the value of such interest not only might be difficult to measure accurately, but would not have been realized by the investor to a greater extent than in the context of a C corporation. In the case of a C corporation, losses and expenses borne by the corporation, and any decline in the value of the corporation's stock, did not give rise to the recognition of any loss on the part of shareholders prior to disposition of their stock.[6]

The distinction that Congress determined should be drawn between activities on the basis of material participation was viewed as unrelated to the question of whether, and to what extent, the taxpayer was at risk with respect to the activities.[7] In general, the fact that a taxpayer placed a particular amount at risk in an activity did not establish, prior to a disposition of the taxpayer's interest, that the amount invested, or any amount, had as yet been lost. The fact that a taxpayer was potentially liable with respect to future expenses or losses of the activity likewise had no bearing on the question whether any amount had as yet been lost, or otherwise was an appropriate current deduction or credit.

At-risk standards, although important in determining the maximum amount that is subject to being lost, were viewed as not a sufficient basis for determining whether or when net losses from an activity should be deductible against other sources of income, or for determining whether an ultimate economic loss had been realized. Congress concluded that its goal of making tax preferences available principally to active participants in substantial businesses, rather than to investors seeking to shelter unrelated income, was best accomplished by examining material participation, as opposed to the financial stake provided by an investor to purchase tax shelter benefits.

In certain situations, however, Congress concluded that financial risk or other factors, rather than material participation, should be the relevant standard. A situation in which financial risk was viewed as relevant related to the oil and gas industry, which was suffering severe hardship due to the worldwide decline of oil prices. Congress decided that relief for this industry required that tax benefits be provided to attract outside investors and, moreover, that such relief should be provided only with respect to investors who were willing to accept an unlimited and unprotected financial risk proportionate to their ownership interests in the oil and gas activities. Granting tax shelter benefits to investors in oil and gas activities who did not accept unlimited risk, proportionate to their ownership investments in the activities, was viewed as permitting the benefit of this special exception to be diverted unduly to the investors, while providing less benefit to oil and gas activities and threatening the integrity of the entire rule limiting the use of nonparticipatory business losses.

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[6] Gain of a C corporation, while generally not taxed to the shareholder prior to distribution, is taxed at the entity level upon recognition.

[7] The at-risk rules of prior law, while important and useful in preventing overvaluation of assets, and in preventing the transfer of tax benefits to taxpayers with no real equity in an activity, were viewed as not addressing the adverse consequences arising specifically from such transfers to nonparticipating investors.

A further area in which the material participation standard was viewed as not wholly adequate was that of rental activities. Such activities predominantly involve the production of income from capital. For this reason, rental income generally was not subject to the self-employment tax, whether or not the activity constituted a trade or business (sec. 1402(a)(1)). Rental activities generally require less ongoing management activity, in proportion to capital invested, than business activities involving the production or sale of goods and services. Thus, for example, an individual who was employed full-time as a professional could more easily provide all necessary management in his spare time with respect to a rental activity than he could with respect to another type of business activity involving the same capital investment. The extensive use of rental activities for tax shelter purposes under prior law, combined with the reduced level of personal involvement necessary to conduct such activities, made clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities.

Congress believed that a limited measure of relief, however, was appropriate in the case of certain moderate-income investors in rental real estate, who otherwise might experience cash flow difficulties with respect to investments that in many cases were designed to provide financial security, rather than to shelter a substantial amount of other income.

Additional considerations were viewed as relevant with regard to limited partnerships. In order to maintain limited liability status, a limited partner generally is precluded from materially participating in the business activity of the partnership; in virtually all respects, a limited partner more closely resembles a shareholder in a C corporation than an active business entrepreneur. Moreover, limited partnerships commonly were used as vehicles for marketing tax benefits to investors seeking to shelter unrelated income. In light of the widespread use of limited partnership interests in syndicating tax shelters, Congress determined that losses from limited partnership interests should not be permitted, prior to a taxable disposition, to offset positive income sources such as salary.

Explanation of Provision

1. Overview

The Act provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity.

The provision applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income in the case of closely held corporations. Special rules also apply to rental activities. Losses from certain working interests in oil and gas property are not limited by the provision. Losses and credits attributable to a limited partnership interest generally are treated as arising from a passive activity. The provision is effective for taxable years beginning after 1986. For certain pre-enactment interests in passive activities, the provision is phased in, and becomes fully effective for taxable years beginning in 1991 and thereafter. Transitional relief is provided for losses from certain existing low-income housing activities.

Losses and credits from a passive activity (taking into account expenses such as interest attributable to acquiring or carrying an interest in the activity) may be applied against income for the taxable year from other passive activities or against income subsequently generated by any passive activity. Such losses (and credits) generally cannot be applied to shelter other income, such as compensation for services or portfolio income (including interest, dividends, royalties, annuities, and gains from the sale of property held for investment). For this purpose, property held for investment generally does not include an interest in a passive activity.

Salary and portfolio income are separated from passive activity losses and credits because the former generally are positive income sources that do not bear deductible expenses to the same extent as passive investments. Since taxpayers commonly can rely upon salary and portfolio income to be positive (and since, when economically profitable, these items generally yield positive taxable income), they are susceptible to sheltering by means of investments in activities that predictably give rise to tax losses (or credits in excess of the tax attributable to income from such investments). The passive loss provision ensures that salary and portfolio income, along with other non-passive income sources, cannot be offset by tax losses from passive activities until the amount of real economic losses from such activities is determined upon disposition.

Under the provision, suspended losses attributable to passive activities are allowed in full upon a taxable disposition of the taxpayer's entire interest in the activity.[8] The full amount of gain or loss from the activity can then be ascertained. To the extent the taxpayer's basis in the activity has been reduced by suspended deductions, resulting in gain on disposition, the remaining suspended deductions will, in effect, offset such gain. However, the character of any gain or loss (i.e., as ordinary or capital gain or loss) is not affected by this provision.

Passive activity

An activity generally is a passive activity if it involves the conduct of any trade or business, and if the taxpayer does not materially participate in the activity. A taxpayer who is an individual materially participates in an activity only if he is involved in the operations of the activity on a regular, continuous, and substantial basis. Regardless of whether an individual owns an interest in a trade or business activity directly (e.g., as a proprietorship), or owns an interest in an activity conducted at the entity level by a passthrough entity such as a general partnership or S corporation, he must be involved in the operations of the activity on a regular, continuous, and substantial basis, in order to be treated as materially participating.

In the case of a limited partnership interest, special considerations apply. The form of entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership. Moreover, since a limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status, Congress concluded that it should not be necessary to examine general facts and circumstances regarding material participation in this context. Therefore, under the Act, a limited partnership interest is treated as intrinsically passive (except as provided in regulations).[9] Portfolio income of a partnership (net of directly allocable expenses and properly allocable interest expense), however, is not treated as passive (see sec. 3, below). A share of partnership income, or a guaranteed payment to a partner (including a limited partner) attributable to the performance of personal services (including past or expected future services) is not to be treated as passive. Losses from trade or business activities that are allocable to a limited partnership interest are not permitted, prior to disposition, to be applied against any income other than income from passive activities.

A passive activity under the Act does not include a working interest in oil or gas property where the taxpayer's form of ownership does not limit his liability. Thus, an owner of such a working interest in oil or gas property is permitted to deduct otherwise allowable losses attributable to the working interest whether or not he materially participates in the activity being conducted through the working interest.

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[8] Gain recognized on a transfer of a partial interest in the passive activity, and gain (boot) on a tax-free transfer of an entire or partial interest, are treated as from a passive activity. Gain on such transfers may be offset by losses and credits from passive activities, but such transfers are not treated as dispositions triggering all suspended losses from the activity.

[9] Such regulatory authority might appropriately address the general situation where an individual holds a limited partnership interest in an activity for which the individual (or spouse) performs personal services, and treatment of net income attributable to the limited partnership interest as income from a passive activity would permit sheltering of the type of positive income meant to be separated from passive losses under the provision. For example, unintended results could arise if net income from an activity were treated as passive where the taxpayer's interest in it is held partly, but not wholly, as a limited partner, and the activity is an integral part of his (or his spouse's) source of livelihood. Thus, the Treasury may provide in regulations that, in appropriate circumstances, a person who is both a general partner and a limited partner in a limited partnership is not treated as passive with respect to the limited partnership interest.

A passive activity is defined to include any rental activity, whether or not the taxpayer materially participates. However, an activity where substantial services are provided, and payments are for such services rather than principally for the use of property, is not a rental activity. For example, operating a hotel or similar transient lodging, where substantial services are provided and payments are not principally for the use of tangible property, is not a rental activity. An activity as a dealer in real estate also generally is not treated as a rental activity.[10] Long-term rentals or leases of property (e.g., apartments, leased office equipment, or leased cars), on the other hand, generally are considered to be rental activities. Losses from rental activities are allowed against income from other passive activities, but not against other income.

Under the provision, passive activities can include activities generating deductions allowable under section 174 of the Code as research and experimentation expenditures. Thus, if a taxpayer has an interest in an activity with respect to which deductions would be allowed as research and experimentation expenditures, and he does not materially participate in the activity, losses from the activity (including the research and experimentation expenditures) are subject to limitation under the rule.

Passive activities that are not a trade or business.—The Act provides that, to the extent provided in regulations, a passive activity may include an activity conducted for profit (within the meaning of sec. 212), including an activity that is not a trade or business. Congress anticipated that the exercise of this authority would be appropriate in certain situations where activities other than the production of portfolio income are involved. This regulatory authority is meant to cause the passive loss rule to apply with respect to activities that give rise to tax losses that can be used to shelter positive income, but that may not rise to the level of a trade or business.

Interaction with interest deduction limitation.—The Act provides that interest expense allocable to passive activities is treated as a passive activity expense and is not treated as investment interest (see Part C, below). Thus, deductions otherwise allowable for such interest expense are subject to limitation under the passive loss rule, and not under the investment interest limitation. Similarly, income and loss from passive activities generally are not treated as investment income or loss in calculating the amount of the investment interest limitation.[11]

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[10] Under the at-risk rules as extended by the Act to the activity of holding real estate, the holding of real property includes the holding of personal property and the providing of services which are incidental to making real property available as living accommodations. Whether an activity constitutes the holding of real estate for purposes of the at-risk rules is not determinative of whether it constitutes a rental activity under the passive loss rule.

[11] However, as described in Part C, below, any passive losses allowed by reason of the phase-in of the passive loss provision reduce net investment income. Passive losses allowed on different grounds (e.g., disposition losses, or losses allowed by reason of the taxpayer's active participation in rental real estate activities) do not so reduce net investment income.

Interest on debt secured by the taxpayer's residence or a second residence is not subject to limitation under the passive loss rule, so long as the interest meets the definition of qualified residence interest under section 163(h) (as amended by the Act; see Part C, below). Thus, if a taxpayer rents out his vacation home (that he has selected as his second residence) and a portion of the mortgage interest (which meets the definition of qualified residence interest) is allocable to rental use of the home which would otherwise be treated as a passive activity, such interest expense is not subject to disallowance under this provision.

Interaction with other Code sections.—The passive loss rule applies to all deductions that are from passive activities, including deductions allowed under sections 162, 163, 164, and 165. For example, deductions for State and local property taxes incurred with respect to passive activities are subject to limitation under the passive loss rule whether such deductions are claimed above-the-line or as itemized deductions under section 164.

Personal service income not treated as from passive activity.—Income received by an individual from the performance of personal services with respect to a passive activity is not treated as income from a passive activity. Thus, for example, in the case of a limited partner who is paid for performing services for the partnership (whether by way of salary, guaranteed payment, or allocation of partnership income), such payments cannot be sheltered by passive losses from the partnership or from any other passive activity.

Rental real estate in which the taxpayer actively participates.—Under the Act, an individual may annually deduct up to $25,000 of passive activity losses (to the extent they exceed income from passive activities) that are attributable to rental real estate activities in which the taxpayer actively participates. The $25,000 offset is not available to corporations or trusts or, except in limited circumstances, to estates.[12] A taxpayer is not treated as actively participating in a rental real estate activity if he has an interest that is less than a 10 percent interest in the activity at any time during the year. Absent a sufficient ownership interest, Congress concluded, the taxpayer's management activity is most likely to relate predominantly to the interests of his co-owners, rather than to the management of his own interest; thus, it does not establish that the taxpayer is active in relation to his interest. A taxpayer is not presumed to be actively participating, however, merely by reason of having a 10 percent or greater interest. As discussed below, the active participation requirement is different from the material participation standard, and generally does not require as much personal involvement.

The $25,000 allowance for losses is phased out ratably as the taxpayer's adjusted gross income (determined without regard to passive activity losses) increases from $100,000 to $150,000. Thus, for example, a middle income taxpayer who has invested in a condominium apartment, and whose involvement in the operations necessary to rent it and maintain it amounts to active participation, may deduct up to $25,000 per year of losses from the rental real estate activity.

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[12] A trust does not qualify for the allowance of up to $25,000 in losses and (deduction equivalent) credits from a rental real estate activity in which there is active participation, so that individuals cannot circumvent the $25,000 ceiling, or multiply the number of $25,000 allowances, simply by transferring various rental real properties to one or more trusts.

The $25,000 allowance for rental real estate applies, in a deduction equivalent sense, to credits attributable to rental real estate activities as well. Under a special rule, the $25,000 allowance applies to low-income housing and rehabilitation credits regardless of whether the taxpayer claiming the credit actively participates in the low-income housing or rehabilitation activity (including in the case of a limited partner). In addition, the adjusted gross income phaseout range for the $25,000 allowance for these two credits is $200,000 to $250,000, rather than $100,000 to $150,000 (as for losses). For purposes of calculating the phase-out of the $25,000 allowance at adjusted gross income between $100,000 to $150,000 (or $200,000 to $250,000, in the case of certain credits), adjusted gross income is calculated without regard to IRA contributions and taxable social security benefits.

A single $25,000 amount (and phaseout thereof) applies on an aggregate basis to credits (including the low-income housing and rehabilitation credits) and to deductions, as opposed to allowing a $25,000 amount for each. If the total net rental real estate losses and credits (deduction equivalents) exceed the $25,000 amount allowable against other income, the taxpayer generally must allocate the allowable amount among activities to determine which of the rental real estate losses and credits (including those suspended in prior years) are allowable. This allocation is necessary for purposes of determining the total suspended losses and credits attributable to each activity, because losses are allowable in full upon a disposition of the taxpayer's entire interest in the activity, and a special election applies with respect to credits.

In performing this allocation, losses are treated as allowed before credits. Losses are allowed before credits because credits are considered in the nature of incentives which may not bear a relation to accurate measurement of income or loss from an activity. As between activities, when there are excess losses (or credits), allocation is *pro rata* with respect to the amount of losses (or credits) from each loss activity. Thus, for example, if a taxpayer who qualifies for the full $25,000 allowance has $10,000 of losses from one activity and $40,000 of losses from a second activity, then $5,000 is treated as allowed from the first activity and $20,000 is treated as allowed from the second activity.

In order to determine the amount of losses potentially qualifying for the $25,000 allowance, it is necessary first to net income and loss from all of the taxpayer's rental real estate activities in which he actively participates. If there is a net loss for the year from such activities, net passive income (if any) from other activities is then applied against it, in determining the amount eligible for the $25,000 allowance.

For example, assume that a taxpayer has $25,000 of losses from a rental real estate activity in which he actively participates. If he also actively participates in another rental real estate activity, from which he has $25,000 of gain, resulting in no net loss from rental real estate activities in which he actively participates, then no amount is allowed under the $25,000 allowance for the year.

This result follows whether or not the taxpayer has net losses from other passive activities for the year.

With respect to active participation, just as with respect to material participation, a change in the nature of the taxpayer's involvement does not trigger the allowance of deductions carried over from prior taxable years. Thus, if a taxpayer begins to actively participate in an activity in which, in prior years, he did not actively participate, the rule allowing up to $25,000 of losses from rental real estate activities against non-passive income does not apply to losses from the activity carried over from such prior years.[13] The same rule applies to credits, to the extent that active participation is relevant to their allowability.

Special rule for estates.—In the case of an estate of a taxpayer who, in the taxable year in which he died, owned an interest in a rental real estate activity in which he actively participated, the estate is deemed to actively participate for the two taxable years of the estate following the death of the taxpayer. Thus, the taxpayer's estate may continue to receive the same tax treatment with respect to the rental real estate activity as did the taxpayer in the taxable year of his death. This treatment applies to the taxpayer's estate until the end of the second taxable year of the estate after his death, to facilitate the administration of the estate without requiring the executor or fiduciary to reach decisions with respect to the appropriate disposition of the rental real property within a short period following the taxpayer's death.

Married individuals filing separately.—The amount of the $25,000 allowance, and the adjusted gross income ranges in which the allowance is phased out (i.e., $100,000 to $150,000, except in the case of certain credits where the range is $200,000 to $250,000) generally are halved in the case of married individuals filing separate returns. In the case of married individuals filing separately, who, at any time during the taxable year, do not live apart, the amount of the $25,000 allowance is reduced to zero. Absent such a rule, married taxpayers where one spouse would be eligible for a portion of the $25,000 amount if they filed separately would have an incentive so to file; Congress concluded that rules that encourage filing separate returns give rise to unnecessary complexity and place an unwarranted burden on the administration of the tax system.

Taxpayers subject to the rule

The passive loss rule applies to individuals, estates and trusts. The rule also applies to personal service corporations without regard to certain limitations in the applicable attribution rules. A corporation is not treated as a personal service corporation for this purpose unless the employee/owners together own more than 10 percent, by value, of the corporation's stock. Congress intended that taxpayers not be able to circumvent the passive loss rule merely by virtue of the form in which they conduct their affairs. Thus, the rule was designed to prevent individuals from being able to shelter income derived from the performance of personal services simply by creating personal service corporations and acquiring tax shelter investments at the corporate level.

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[13] By contrast, losses (or credits) carried over from a year in which the taxpayer did actively participate, but that were not allowed against non-passive income in such year because they exceeded $25,000 (as reduced by the applicable AGI phaseout), are deductible (or allowable) under the $25,000 rule in a subsequent year, but only if the taxpayer is actively participating in the activity in such subsequent year.

It also was not intended that incorporation of an individual's portfolio investments be available as a way to avoid the passive loss rule. For this reason, the passive loss rule, in modified form, applies to all closely held C corporations (other than personal service corporations, which are subject to the general passive loss rule) that are subject to the at-risk rules (generally, where 5 or fewer individuals, directly or indirectly, own more than 50 percent of the stock).[14] Such C corporations may not offset losses or credits from passive activities against portfolio income. Such corporations may, however, offset passive losses and credits against active business income (i.e., trade or business income which is not from a passive activity).

Thus, for example, if a closely held C corporation has $400,000 of passive losses from a rental activity, $500,000 of active business income, and $100,000 of portfolio income, the passive losses may be applied to reduce the active business income to $100,000, but may not be applied against the portfolio income.[15] In determining whether a corporation materially participates in an activity, and hence whether the activity is a passive activity, the material participation in the corporation's activity of corporate employees and owners is examined. As is generally true under the passive loss rule, losses and credits from a non-passive trade or business activity are not subject to any special limitation.

Affiliated groups.—In the case of affiliated groups of corporations filing consolidated returns, Congress determined that the passive loss limitation should be applied on a consolidated group basis. Thus, for example, it was intended that losses from any passive activity within a consolidated group that is treated as closely held under the rule be permitted to offset net active income, but not portfolio income, of the group. In general, under the rule, an activity may be conducted by several corporations, just as one corporation may be engaged in several activities. Portfolio income is accounted for separately from income or loss from each activity.

In determining whether an activity (other than a rental activity) conducted within the closely held consolidated group is a passive activity, the material participation test was intended to be applied on a consolidated basis. Thus, for example, if one or more individual shareholders holding stock representing more than 50 percent of the common parent's stock materially participate in an activity of any member of the group, the group is considered to materially participate. Similarly, if the requirements of section 465(c)(7)(C) (without regard to clause (iv) thereof) are met with respect to an activity by any member (or several members together), then the group is considered to materially participate in the activity.

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[14] Closely held C corporations that also constitute personal service corporations for purposes of the passive loss rule are subject to the rule in full, rather than to the more limited closely held rule.

[15] See colloquy between Senators Johnston and Packwood, 132 Cong. Rec. S13958-9 (September 27, 1986), and statement of Mr. Rostenkowski affirming the colloquy at 132 Cong. Rec. E 3390 (October 2, 1986).

In the case of a personal service corporation which is a member of a consolidated group, similar principles were intended to apply. For example, a corporation may be treated as a personal service corporation for purposes of the rule where the owners who render the requisite services are employees of a subsidiary, rather than of the parent corporation. The Act provides that the definition of a personal service corporation is applied taking into account attribution of ownership of stock as provided in section 269A(b), with certain modifications.

2. Treatment of losses and credits

In general

Losses.—Losses arising from a passive activity generally are deductible only against income from that or another passive activity. Suspended passive activity losses for the year are carried forward indefinitely, but are not carried back, and are allowed in subsequent years against passive activity income. Suspended losses from an activity are allowed in full upon a taxable disposition of the activity, as discussed below.

If any passive losses are not deductible in any given year, the amount of the suspended losses from each passive activity is determined on a pro rata basis. With respect to each activity, the portion of the loss that is suspended, and carried forward, is determined by the ratio of net losses from that activity to the total net losses from all passive activities for the year. This allocation is necessary in order to determine the suspended losses for any particular activity, which are allowed in full upon a disposition.

In the case of the $25,000 allowance for passive losses from rental real estate activities in which an individual actively participates, a situation could arise in which losses would be allowable for the year under the passive loss rule, but the taxpayer has insufficient (or no) non-passive income against which to apply them. In such a case, the otherwise allowable rental real estate losses are thereupon treated as losses which are not from a passive activity. They may give rise to net operating losses (NOLs) treated as arising in that year, and may be carried forward and back in accordance with the rules applicable to NOLs.

In general, NOL carryovers, like current-year losses other than passive losses, are allowed against any income of the taxpayer.[16] In the case of individuals, estates and trusts, and personal service corporations, however, such nonpassive losses and NOLs are taken into account only after reducing income from passive activities by current and suspended deductions from passive activities (but not below zero). Thus, the application of any prior-year suspended passive losses against current year passive income is taken into account before such NOLs are applied against net passive income. This permits the taxpayer to obtain the full benefit of suspended passive activity losses (which are limited in application) before using any losses that are not from passive activities (or NOL carryovers). If a taxpayer has net passive activity income for the year (after the application of all suspended passive losses), the income may be offset by current-year non-passive losses and by NOL carryovers.

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[16] For example, net operating losses carried forward from taxable years prior to 1987 are not limited under the passive loss rule even though they may arise from activities that, once the provision becomes effective, are treated as passive activities.

In the case of a closely held C corporation (other than a personal service corporation), the passive loss rule applies in modified form: passive losses may be used to offset active business income, but not portfolio income. In applying this rule, losses from passive activities (including such losses carried over from prior years after the effective date) are offset against income from passive activities to determine the aggregate passive loss, if any. If there is such a loss, it may be applied only against active business income, but not portfolio income, of the corporation. As is generally the case, NOLs are applied after the application of the passive loss rule.

The determination of whether a loss is suspended under the passive loss rule is made after the application of the at-risk rules. A loss that would not be allowed for the year because the taxpayer is not at risk with respect to it is suspended under the at-risk provision, not the passive loss rule. Such amounts may become subject to the passive loss rule in subsequent years when they would be allowable under the at-risk rule.[17]

Under the Act, interest deductions allocable to passive activities are subject to the passive loss rule (as under the Senate amendment), but are not subject to the investment interest limitation (see Part C., below). Thus, for example, if a taxpayer has net passive losses of $100 for a taxable year beginning after 1986, $40 of which consists of interest expense, the entire $100 is subject to limitation under the passive loss rule, and no portion of the loss is subject to limitation under the investment interest limitation.

Credits.—Credits arising with respect to passive activities generally are treated in the same manner as deductions.[18] That is, credits may not be used to offset tax attributable to income other than passive income. The amount of tax attributable to net passive income is determined by comparing (i) the amount that the taxpayer would pay with regard to all income, with (ii) the amount that the taxpayer would pay with regard to taxable income other than net passive income (disregarding, in both cases, the effect of credits).

For example, if a taxpayer would owe $50,000 of tax disregarding net passive income, and $80,000 of tax considering both net passive and other taxable income (in both cases, disregarding the effect of credits), then the amount of tax attributable to passive income is $30,000. In this case, any passive credits not in excess of $30,000 attributable to the taxpayer's passive activities are allowable. Any passive credits not in excess of $30,000 are, in addition, subject to other limitations applicable to the allowance of credits. In the absence of net passive income for a taxable year, no tax is attributable to passive income, and passive credits generally are not allowable for the year.

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[17] Amounts at risk are reduced even if deductions which would be allowed under the at-risk rules are suspended under the passive loss rule. Similarly, basis is reduced as under present law, even in the case where deductions are suspended under the passive loss rule. However, if an amount at risk or basis has been reduced by a deduction not allowed under the passive loss rule, the amount at risk or basis is not again reduced when the deduction becomes allowable under the passive loss rule.

[18] The allowability of foreign tax credits, however, is unaffected by the passive loss provision. Instead, foreign tax credits are limited solely by the various rules applying generally to such credits (e.g., the sec. 904 limitation, which is applied after determining the amounts of foreign source and worldwide income consistently with the application of the passive loss rule).

Passive credits may be allowable to offset tax on income other than passive income with respect to the special rule providing up to $25,000 of benefit for certain rental real estate activities. Under this rule, credits are allowed to offset tax on the portion of the $25,000 (or less, as appropriate) that the taxpayer has not been able to offset by the use of deductions.

The amount of tax on such remaining portion (and thus, the amount of credits that can be used against other income, assuming that there are sufficient credits available) is determined by comparing (i) the amount that the taxpayer would owe (disregarding credits) with respect to income other than any net passive losses, but reduced by rental real estate deductions in the full amount allowable under the $25,000 rule, with (ii) the amount that the taxpayer would owe (again disregarding credits) if the allowable rental real estate deductions equalled $25,000 (or less as appropriate, i.e., in the phaseout range for this amount).

In general, credits arising with respect to passive activities, like deductions relating to such activities, can be carried forward indefinitely, and cannot be carried back. However, the character of a credit relating to a passive activity changes, in effect, when the credit becomes allowable under the passive loss rule (i.e., there either is sufficient passive income to allow its use, or it is within the scope of the $25,000 benefit for rental real estate activities). At such time, such credit is aggregated with credits relating to nonpassive activities of the taxpayer, for purposes of determining whether all such credits are allowable in light of other limitations applying to the use of credits (e.g., the 75 percent tax liability limitation, and the provision that credits cannot be used to reduce regular tax liability to less than tentative minimum tax liability).

In the event that any credits are not allowable because of such other limitations, the passive credits that are allowable under the passive activity rules are thereupon treated as non-passive credits arising in the current taxable year. Thus, the treatment of such credits then is determined in all respects by the general rules applying to such credits, including carryover periods.[19] The credit carryover periods begin to run, with respect to a credit (or portion thereof) theretofore disallowed under the passive loss rule, in the year when the credit (or portion thereof) first is allowable under the passive loss rule. This treatment of credit carryover periods is distinguishable from the treatment of credits under the credit at-risk rules (sec. 46).

The Act provides that for the rehabilitation and low-income housing credits, the phase-out range for offsetting tax on up to $25,000 of non-passive income is increased to between $200,000 and $250,000 of adjusted gross income (calculated without regard to net passive losses, IRA contributions, or taxable social security benefits), and such credits are allowed under the $25,000 rule regardless of whether the taxpayer actively participates in the activity generating the credits. In the case of the low-income housing credit, the increase in the phase-out range (to between $200,000 and $250,000, as opposed to between $100,000 and $150,000 as for other rental real estate losses and credits), and the waiver of the requirement that the taxpayer actively participate in the activity generating the low-income housing credit, apply only with respect to the original credit compliance period for the property, and only to property placed in service before 1990, except if the property is placed in service before 1991, and 10 percent or more of the total project costs are incurred before 1989.

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[19] Credits that are subject to special limitations (e.g., the limitation on the use of research and development credits to offset certain unrelated income of the taxpayer) continue to be subject to such limitations when they cease to be limited by the passive activity rules.

This increase in the adjusted gross income phase-out range may be illustrated as follows. Assume that an individual has $5,000 (deduction equivalent amount) of low-income housing credits from a limited partnership interest (in which, under the passive loss rule, he is considered not to materially or actively participate) in a rental real estate activity. His adjusted gross income (determined without regard to passive losses) is $200,000, and he has no other passive losses, credits or income for the year. The individual is permitted under the $25,000 allowance rule to take the low income housing credit.

Other credit limitations.—The limitation on the credit for research and development activities to the tax on income from such activities is applied before the passive loss limitation is applied to such credits. The overall limitation on credits under the Act (providing that credits generally cannot offset more than 75 percent of the taxpayer's tax liability for the year or reduce regular tax below tentative minimum tax) is applied after the amount of credits allowable under the passive loss rule is determined. Once a credit is allowed for a year under the passive loss rule, it is treated as an active credit arising in that year.

Dispositions

In general.—When a taxpayer disposes of his entire interest in a passive activity, the actual economic gain or loss on his investment can be finally determined. Thus, under the passive loss rule, upon a fully taxable disposition, any overall loss from the activity realized by the taxpayer is recognized and allowed against income (whether active or passive income). This result is accomplished by triggering suspended losses upon disposition.

The reason for this rule is that, prior to a disposition of the taxpayer's interest, it is difficult to determine whether there has actually been gain or loss with respect to the activity. For example, allowable deductions may exceed actual economic costs, or may be exceeded by untaxed appreciation. Upon a taxable disposition, net appreciation or depreciation with respect to the activity can be finally ascertained. Since the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted, credits, which are not related to the measurement of such loss, are not specially allowable by reason of a disposition. Disallowed credits are carried forward (but not back) until they become allowable under the passive loss rule, as discussed above.

Taxable dispositions of entire interest in activity.—The type of disposition that triggers full recognition of any loss from a passive activity (and of suspended losses from a former passive activity) is a fully taxable disposition of the taxpayer's entire interest in the activity to an unrelated person. A fully taxable disposition generally includes a sale of the property to a third party at arm's length, and thus, presumably, for a price equal to its fair market value. Gain realized upon a transfer of an interest in a passive activity generally is treated as passive, and is first offset by the suspended losses from that activity. This accomplishes the purpose of the rule to recognize net income or loss with respect to the activity when it can be finally determined.

Where the taxpayer transfers an interest in a passive activity in a transaction in which the form of ownership merely changes, suspended losses generally are not allowed, because the gain or loss he has realized with respect to the activity has not been finally determined. (Such suspended losses are allowed, however, to the extent that any gain recognized on such a transfer, together with other income from passive activities for the year, exceeds losses from passive activities for the year.) Special rules are provided for gifts and in the case of death of the taxpayer. No disposition occurs when the taxpayer is treated as no longer subject to the passive loss rule with respect to the activity (i.e., where the taxpayer does not dispose of his interest in the activity, but it is treated as no longer passive).

The taxpayer must dispose of his entire interest in the activity in order to trigger the recognition of loss. If he disposes of less than his entire interest, then the issue of ultimate economic gain or loss on his investment in the activity remains unresolved. A disposition of the taxpayer's entire interest involves a disposition of the taxpayer's interest in all entities that are engaged in the activity, and to the extent held in proprietorship form, of all assets used or created in the activity. If a partnership or S corporation conducts two separate activities, fully taxable disposition by the entity of all the assets used or created in one activity constitutes a disposition of the partner's or shareholder's entire interest in the activity. Similarly, if a grantor trust conducts two separate activities, and sells all the assets used or created in one activity, the grantor is considered as disposing of his entire interest in that activity. If the taxpayer has adequate records of the suspended losses that are allocable to that activity, and includes in income the gain (if any) allocable to his entire interest in the activity, such losses are allowed in full upon the disposition.

An installment sale of the taxpayer's entire interest in an activity in a fully taxable transaction triggers the allowance of suspended losses. The losses are allowed in the ratio that the gain recognized in each year bears to the total gain on the sale.

A transfer of a taxpayer's interest in an activity by reason of his death causes suspended losses to be allowed to the extent they exceed the amount, if any, by which the basis of the interest in the activity is increased at death under section 1014. Suspended losses are eliminated to the extent of the amount of the basis increase. The losses allowed generally would be reported on the final return of the deceased taxpayer.

A transaction constituting a sale (or other taxable disposition) in form, however, to the extent not treated as a taxable disposition under general tax rules, does not give rise to the allowance of suspended deductions. For example, sham transactions, wash sales, and transfers not properly treated as sales due to the existence of a put, call, or similar right relating to repurchase, do not give rise to the allowance of suspended losses.

Related party transactions.—The Act provides that the taxpayer is not treated as having disposed of an interest in a passive activity, for purposes of triggering suspended losses, if he disposes of it in an otherwise fully taxable transaction to a related party (within the meaning of sec. 267(b) or 707(b)(1), including applicable attribution rules). In the event of such a related party transaction, because it is not treated as a disposition for purposes of the passive loss rule, suspended losses are not triggered, but rather remain with the taxpayer. Such suspended losses may be offset by income from passive activities of the taxpayer.

When the entire interest owned by the taxpayer and the interest transferred to the related transferee in the passive activity are transferred to a party who is not related to the taxpayer (within the meaning of sec. 267(b) or 707(b)(1), including applicable attribution rules) in a fully taxable disposition, then to the extent the transfer would otherwise qualify as a disposition triggering suspended losses, the taxpayer may deduct the suspended losses attributable to his interest in the passive activity.

Certain insurance transactions.—In the case of certain transactions involving dispositions of interests in syndicates that insure U.S. risks, generally, when an owner of an interest in such a syndicate that is treated as a passive activity enters into a transaction whereby he disposes of his interest in the syndicate in a fully taxable closing transaction, he is treated as having made a disposition of his interest in the passive activity.

Abandonment.—The scope of a disposition triggering suspended losses under the passive loss rule includes an abandonment, constituting a fully taxable event under present law, of the taxpayer's entire interest in a passive activity. Thus, for example, if the taxpayer owns rental property which he abandons in a taxable event which would give rise to a deduction under section 165(a), the abandonment constitutes a taxable disposition that triggers the recognition of suspended losses under the passive loss rule.

Similarly, to the extent that the event of the worthlessness of a security is treated under section 165(g) of the Code as a sale or exchange of the security, and the event otherwise represents the disposition of an entire interest in a passive activity, it is treated as a disposition. No inference is intended with respect to whether a security includes an interest in any entity other than a corporation.

Interaction with capital loss limitation.—Upon a fully taxable disposition of a taxpayer's entire interest in a passive activity, the passive loss rule provides that any deductions previously suspended with respect to that activity are allowed in full. However, to the extent that any loss recognized upon such a disposition is a loss from the sale or exchange of a capital asset, it is limited to the amount of gains from the sale or exchange of capital assets plus $3,000 (in the case of individuals). The limitation on the deductibility of capital losses is applied before the determination of the amount of losses allowable upon the disposition under the passive loss rule.

Thus, for example, if a taxpayer has a capital loss of $10,000 upon the disposition of a passive activity, and is also allowed to deduct $5,000 of previously suspended ordinary losses as a result of the disposition, the $5,000 of ordinary losses are allowed, but the capital loss deduction is limited to $3,000 for the year (assuming the taxpayer has no other gains or losses from the sale of capital assets for the year). The remainder of the capital loss from the disposition is carried forward and allowed in accordance with the provisions determining the allowance of such capital losses.

Basis adjustment for credits.—Under the Act, an election is provided in the case of a fully taxable disposition of an interest in an activity in connection with which a basis adjustment was made as a result of placing in service property for which a credit was taken. Upon such a disposition, the taxpayer may elect to increase the basis of the credit property (by an amount no greater than the amount of the original basis reduction of the property) to the extent that the credit has not theretofore been allowed by reason of the passive loss rule. At the time of the basis adjustment election, the amount of the suspended credit which may thereafter be applied against tax liability is reduced by the amount of the basis adjustment. The purpose for providing this election is to permit the taxpayer to recognize economic gain or loss, taking account of the full cost of property for which no credit was allowed.

This rule may be illustrated as follows. A taxpayer places in service rehabilitation credit property generating an allowable credit of $50, and reduces the basis of the property by $50 as required by the provisions governing the rehabilitation credit, but is prevented under the passive loss rule from taking any portion of the credit. In a later year, having been allowed no portion of the credit by virtue of the passive loss rule, the taxpayer disposes of his entire interest in the activity, including the property whose basis was reduced. Immediately prior to the disposition, the taxpayer may elect to increase basis of the credit property by the amount of the original basis adjustment (to the extent of the amount of the unused credit) with respect to the property.

If the property is disposed of in a transaction that, under the passive loss rule, does not constitute a fully taxable disposition of the taxpayer's entire interest in the passive activity, then no basis adjustment may be elected at any time. To the extent the credit has been suspended by virtue of the passive loss rule, however, it may remain available to offset tax liability attributable to passive income.

Disposition of activity of limited partnership.—In general, under the passive loss rule, suspended deductions are allowed upon a taxable disposition of the taxpayer's entire interest in an activity, because it becomes possible at that time to measure the taxpayer's actual gain or loss from the activity. A disposition of the taxpayer's entire interest in an activity conducted by a limited partnership, like a disposition of an activity conducted in any other form, may constitute a disposition giving rise to the allowance of suspended deductions from the activity.

Nevertheless, it is the intent of Congress that a limited partnership interest in an activity is (except as provided in Treasury regulations) treated as an interest in a passive activity. Because a limited partner generally is precluded from materially participating in the partnership's activities, losses and credits attributable to the limited partnership's activities are generally treated as from passive activities, except that items properly treated as portfolio income and personal service income are not treated as passive.

Changes in nature of activity.—The fact that the nature of an activity changes in the course of its development does not give rise to a disposition for purposes of the passive loss provision. For example, when a real estate construction activity becomes a rental activity upon the completion of construction and the commencement of renting the constructed building, the change is not treated as a disposition.

Other transfers

A gift of all or part of the taxpayer's interest in a passive activity does not trigger suspended losses. However, if he has given away his entire interest, he cannot make a future taxable disposition of it. Suspended losses are therefore added to the basis of the property (i.e., the interest in the activity) immediately before the gift. Similarly, if the taxpayer gives away less than all of his interest, an allocable portion of any suspended losses are added to the donee's basis.[20] Suspended losses of the donor are eliminated when added to the donee's basis, and the remainder of the losses continue to be suspended in the donor's hands. The treatment of subsequent deductions from the activity, to the extent of the donee's interest in it, depends on whether the activity is treated as passive in the donee's hands.

An exchange of the taxpayer's interest in an activity in a nonrecognition transaction, such as an exchange governed by sections 351, 721, or 1031 in which no gain or loss is recognized, does not trigger suspended losses. Following such an exchange, the taxpayer retains an interest in the activity (or, e.g., in another like-kind activity), and hence has not realized the ultimate economic gain or loss on his investment in it. To the extent the taxpayer does recognize gain on the transaction (e.g., boot in an otherwise tax-free exchange), the gain is treated as passive activity income, against which passive losses may be deducted.

The suspended losses not allowed upon such a nonrecognition transaction continue to be treated as passive activity losses of the taxpayer, except that in some circumstances they may be applied against income from the property received in the tax-free exchange which is attributable to the original activity.[21] Such suspended losses may not be applied against income from the property which is attributable to a different activity from the one which the taxpayer exchanged.[22]

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[20] For purposes of determining the donee's loss in a subsequent transaction, however, the donee's basis may not exceed the fair market value of the gift at the time the donee received it. *See*, sec. 1015(a). As under prior law, losses attributable to unrealized depreciation in value of the property at the time of the gift are not deductible.

[21] This rule does not apply, however, to permit the offset of suspended passive losses against dividends or other income or gain otherwise treated as portfolio income. In addition, following some transactions such as a sec. 1031 like-kind exchange, for example, the taxpayer may no longer have an interest in the original activity. Therefore, there is no special rule permitting suspended losses from the prior interest to be offset by income from the new activity, unless it, too, is a passive activity.

Activity no longer treated as passive activity

Other circumstances may arise which do not constitute a disposition, but which terminate the application of the passive loss rule to the taxpayer generally, or to the taxpayer with respect to a particular activity. For example, an individual who previously was passive in relation to a trade or business activity which generates net losses may begin materially participating in the activity. When a taxpayer's participation in an activity is material in any year after a year (or years) during which he was not a material participant, previously suspended losses remain suspended and continue to be treated as passive activity losses. Such previously suspended losses, however, unlike passive activity losses generally, are allowed against income from the activity realized after it ceases to be a passive activity with respect to the taxpayer. As with tax-free exchanges of the taxpayer's entire interest in an activity, however, the taxpayer must be able to show that such income is from the same activity in which the taxpayer previously did not materially participate.[23]

A similar situation arises when a corporation (such as a closely held C corporation or personal service corporation) subject to the passive loss rule ceases to be subject to the passive loss rule because it ceases to meet the definition of an entity subject to the rule. For example, if a closely held C corporation makes a public offering of its stock and thereafter ceases to meet the stock ownership criteria for being closely held, it is no longer subject to the passive loss rule. The corporation's ownership has been so broadened that the reason for limiting the corporation's ability to shelter its portfolio income becomes less compelling. A corporation which is not closely held is less susceptible to treatment as the alter ego of its shareholders, but competing considerations also apply. So as not to encourage tax-motivated transactions involving free transferability of losses, the suspended passive losses are not made more broadly applicable (i.e., against portfolio income) by the change in ownership, but continue to be applicable against all income other than portfolio income of the corporation. Deductions arising in years after the year in which the corporation's status changes are not subject to limitation under the passive loss rule.

The Act provides that the rule applicable to a change in status of a closely held C corporation also applies to a change in status of a personal service corporation. That is, if a personal service corporation ceases to meet the definition of a personal service corporation subject to the passive loss rule in any year, losses from a passive activity conducted by the corporation and previously suspended by reason of the application of the passive loss rule are not triggered by the change in status, but are allowed against income from that activity. Any previously suspended losses and (deduction equivalent) credits in excess of income from the activity continue to be treated as from a passive activity. Losses and credits from an activity arising in a year when the corporation does not meet the definition of a personal service corporation (or a closely held C corporation) are not subject to limitation under the passive loss rule.

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[22] For example, suspended passive activity losses cannot be applied against portfolio income of a pass-through entity.

[23] The reason for this treatment is that the taxpayer could have deducted the suspended losses against income from the activity had the change in his relation to the activity not occurred. Although income from the activity may no longer be passive activity income, prior passive activity losses generated by *that activity* continue to be deductible against income from the activity. It would be inequitable to give less favorable treatment to a taxpayer whose income from an activity becomes active (i.e., not passive) than to one who continues to be merely a passive investor.

3. Treatment of portfolio income

In general

Under the Act, portfolio income is not treated as income from a passive activity, and passive losses and credits generally may not be applied to offset it. Portfolio income generally includes interest, dividends, annuities, and royalties. Also included in portfolio income are gain or loss attributable to disposition of (1) property that is held for investment (and that is not a passive activity) and (2) property that normally produces interest, dividend, annuity, or royalty income.

Portfolio investments ordinarily give rise to positive income, and are not likely to generate losses which could be applied to shelter other income. Therefore, for purposes of the passive loss rule, portfolio income generally is not treated as derived from a passive activity, but rather is treated like other positive income sources such as salary. To permit portfolio income to be offset by passive losses or credits would create the inequitable result of restricting sheltering by individuals dependent for support on wages or active business income, while permitting sheltering by those whose income is derived from an investment portfolio.

Under the Act, dividends on C corporation stock,[24] dividends, and income from a REIT, RIC, or REMIC, interest on debt obligations, and royalties from the licensing of property generally are included in portfolio income. Similarly, gains (or losses) from the sale of interests which normally produce such income are treated as portfolio income or losses. These types of assets ordinarily are positive income sources. On the other hand, except as provided below, income from a general or limited partnership interest, from S corporation stock, from a grantor trust, or from a lease of property generally are not treated as portfolio income. Such interests can generate losses which may be applied to shelter unrelated income of the taxpayer. In addition, although such interests might otherwise be considered as held for investment, gains from the sale of such interests, when they are interests in passive activities, are not treated as portfolio income, except to the extent gain on sale of such interests is itself attributable to portfolio income. For example, if a general partnership owns a portfolio of appreciated stocks and bonds and also conducts a business activity, a part of the gain on sale of a partnership interest would be attributable to portfolio income and would, consequently, be treated as portfolio income.

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[24] Similarly, dividends paid by an S corporation that was formerly a C corporation, that are treated as derived from earnings and profits from a C corporation year under Code sec. 1368, are treated as portfolio income, even though the income or loss passed through to the S corporation shareholders would otherwise be treated as passive. Subpart F income that is included in the taxpayer's gross income under sec. 951 is likewise treated as portfolio income.

Portfolio income of a passive activity is taken into account separately from other items relating to the activity. Thus, for example, portfolio income of an entity which is not attributable to, or part of, an activity of the entity that constitutes a passive activity is accounted for separately from any passive income or loss. Where a taxpayer has an interest in a passive activity, portfolio income of the activity is not taken into account in determining passive income or loss from the activity. Rather, such portfolio income is treated as non-passive income of the taxpayer. This rule is necessary in part because taxpayers otherwise would be able to shelter portfolio income to the extent that they transferred the assets from which it is derived to passive activities in which they had investment interests.

The application of the rule can be explained with regard to the example of a limited partnership that is engaged in the publication of a magazine. The partnership also holds a portfolio of dividend and interest bearing securities, but the income from them is more than offset by the tax losses of operating the magazine. Each limited partner must separately account for his share of the portfolio income and the losses from the operations of the magazine, and may not offset them against each other in calculating his tax liability. The portfolio income retains its character as income that is not income from a passive activity, despite the fact that non-portfolio income and loss attributable to a limited partnership interest is treated as income or loss from a passive activity.

The rule treating portfolio income as not from a passive activity does not apply to the extent that income, of a type generally regarded as portfolio income, is derived in the ordinary course of a trade or business. For example, the business income of a bank typically is largely interest. Similarly, a securities broker/dealer may earn a substantial portion of the income from the business in the form of dividends and gains on sales of dividend-bearing instruments. Interest income may also arise in the ordinary course of a trade or business with respect to installment sales and interest charges on accounts receivable.

In these cases, the rationale for treating portfolio-type income as not from the passive activity does not apply, since deriving such income is what the business activity actually, in whole or in part, involves. Accordingly, interest, dividend, annuity, or royalty income which is derived in the ordinary course of a trade or business is not treated, for purposes of the passive loss provision, as portfolio income. If a taxpayer directly, or through a passthrough entity, owns an interest in an activity deriving such income, such income is treated as part of the activity, which, as a whole, may or may not be treated as passive, depending on whether the taxpayer materially participates in the activity.

The rationale for treating interest income as portfolio income normally does apply, however, in the case where a taxpayer makes a complete disposition of his interest in a passive activity (triggering suspended losses), and the consideration is an interest-bearing instrument. Although the gain, if any, on such a disposition is generally treated as passive income, the interest on the instrument is appropriately treated as portfolio income, where the disposition (as is likely to be true of dispositions of entire interests in passive activities) is not a transaction arising in the ordinary course of a trade or business.

No exception is provided for the treatment of portfolio income arising from working capital, i.e., amounts set aside for the reasonable needs of the business. Although setting aside such amounts may be necessary to the trade or business, earning portfolio income with respect to such amounts is investment-related and not a part of the trade or business itself. Under this rule, for example, interest earned on funds set aside by a limited partnership operating a shopping mall, for the purpose of expanding the mall, is treated as portfolio income and is not taken into account in determining a limited partner's passive income or loss from the activity of operating the shopping mall.

Expenses allocable to portfolio income.—The Act provides that portfolio income is reduced by the deductible expenses (other than interest) that are clearly and directly allocable to such income. Properly allocable interest expense also reduces portfolio income. Such deductions accordingly are not treated as attributable to a passive activity.

The Congress anticipated that the Treasury Department would issue regulations setting forth standards for appropriate allocation of expenses and interest under the passive loss rule. These regulations should be consistent with the purpose of the passive loss rules to prevent sheltering of income from personal services and portfolio income with passive losses. Moreover, the regulations should attempt to avoid inconsistent allocation of interest deductions under different Code provisions.[25]

In the case of entities, a proper method of allocation may include, for example, allocation of interest to portfolio income on the basis of assets, although there may be situations in which tracing is appropriate because of the integrated nature of the transactions involved. Because of the difficulty of recordkeeping that would be required were interest expense of individuals allocated rather than traced, it is anticipated that, in the case of individuals, interest expense generally will be traced to the asset or activity which is purchased or carried by incurring or continuing the underlying indebtedness.

Self-charged interest.—A further issue with respect to portfolio income arises where an individual receives interest income on debt of a passthrough entity in which he owns an interest. Under certain circumstances, the interest may essentially be "self-charged," and thus lack economic significance. For example, assume that a taxpayer charges $100 of interest on a loan to an S corporation in which he is the sole shareholder. In form, the transaction could be viewed as giving rise to offsetting payments of interest income and passthrough interest expense, although in economic substance the taxpayer has paid the interest to himself.[26]

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[25] For example, an interest deduction that is disallowed under sec. 265 should not be allowed, capitalized, or suspended under another provision.

[26] Similar considerations apply where a partnership makes a loan to a partner (e.g., to finance such partner's purchase of all or part of his interest in the partnership, and the interest expense may be treated as part of his passive loss).

Under these circumstances, it is not appropriate to treat the transaction as giving rise both to portfolio interest income and to passive interest expense. Rather, to the extent that a taxpayer receives interest income with respect to a loan to a passthrough entity in which he has an ownership interest, such income should be allowed to offset the interest expense passed through to the taxpayer from the activity for the same taxable year.

The amount of interest income of the partner from the loan that is appropriately offset by the interest expense of the partnership on the loan should not exceed the taxpayer's allocable share of the interest expense to the extent not increased by any special allocation. For example, assume that an individual has a 40-percent interest in a partnership that conducts a business activity in which he does not materially participate, and the individual makes a loan to the partnership on which the partnership pays $100 of interest expense for the year. Since 40 percent of the partnership's interest expense is allocable to the individual, only $40 of the partner's $100 of interest income should be permitted to offset his share of the partnership interest expense, and the remaining $60 is properly treated as portfolio income that cannot be offset by passive losses.

Congress anticipated the issuance of Treasury regulations to provide for the above result. Such regulations may also, to the extent appropriate, identify other situations in which netting of the kind described above is appropriate with respect to a payment to a taxpayer by an entity in which he has an ownership interest. The netting permitted in any such instances should not, however, permit any passive deductions to offset non-passive income except to the extent of the taxpayer's allocable share of the specific payment at issue. Similar considerations should apply in the consolidated return context.

Regulatory authority of Treasury in defining non-passive income.—The Act instructs the Treasury to provide such regulations as may be necessary or appropriate to carry out the purpose of the passive loss provisions, i.e., to prevent the sheltering of positive income sources through the use of tax losses derived from passive activities. Specifically, the Treasury is authorized to provide by regulations that certain items of gross income will not be taken into account in determining income or loss from any activity (and to provide for the appropriate treatment of expenses allocable to such income). The Act also specifically authorizes regulations under which net income or gain from a limited partnership or other passive activity are treated as not from a passive activity.

Congress intended such regulations to prevent taxpayers from structuring income-producing activities (including those that do not bear significant expenses) in ways that are designed to produce passive income that may be offset by unrelated passive losses. For example, regulations may provide that, in order to prevent avoidance of the passive loss rule, a limited partner's share of income from a limited partnership is treated as not from a passive activity. Circumstances in which such treatment could be appropriate would include a transfer by a corporation of an income-producing activity to a limited partnership with a distribution to shareholders of limited partnership interests. The regulations might also treat as not passive those activities that previously generated active business losses and that the taxpayer, with the purpose of circumventing the passive loss rule, intentionally seeks to treat as passive at a time when they generate net income. A further example of a situation where regulatory authority might appropriately be exercised is the case of related party leases or sub-leases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income. In addition, regulatory authority could address the situation of ground rents that produce income without significant expenses.

Treatment of closely held corporations

The passive loss rule applies to closely held C corporations (other than personal service corporations) in modified form. Such corporations may offset passive losses and credits against active business income, but not against portfolio income. Portfolio income of a closely held corporation generally has the same definition as portfolio income of any other taxpayer subject to the passive loss rule, except that, for purposes of such a corporation (as well as for a personal service corporation) the dividends received deduction is allowed.

4. Material participation

General rule

In general, a taxpayer's interest in a trade or business activity is not treated as an interest in a passive activity for a taxable year if the taxpayer materially participates in the activity throughout such year.[27] In certain instances, however, material participation is not determinative. Working interests in oil and gas properties generally are treated as active whether or not the taxpayer materially participates, and interests in rental activities are treated as passive whether or not the taxpayer materially participates. In the case of rental real estate activities, a separate standard, active participation, is relevant in determining whether the taxpayer is permitted to use losses and credits from such activities to offset up to $25,000 of other income.

Working as an employee, and providing services as part of a personal service business (including professional businesses such as law, accounting, and medicine), intrinsically require personal involvement by the taxpayer. Thus, by their nature, they are not passive activities.[28]

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[27] This rule is applied by considering services provided both by the taxpayer and by the taxpayer's spouse (whether or not such taxpayer and spouse file a joint return). Further, it is intended that in determining whether the taxpayer has materially participated throughout the year, all the facts and circumstances are to be taken into account. Thus, for example, if the taxpayer's involvement rises to the level of material participation in an activity on some, but not all, days during the year, but the taxpayer's involvement for the year as a whole is regular, continuous and substantial, then the taxpayer has materially participated for the year. Material participation is determined with respect to the activity for the entire period during the year that he owns an interest in the activity (not, e.g., prorated between periods of greater or lesser involvement). For example, the fact that a taxpayer takes vacations during the year can be fully consistent with a finding of material participation.

[28] The generally "active" nature of the above two undertakings is relevant, not only to the question of whether the taxpayer satisfies the material participation standard, but also to whether either of such two undertakings can be part of the same activity as any other undertaking. *See* sec. 5, *infra*.

Material participation of a taxpayer in an activity is determined separately for each taxable year. In most cases, the material participation (or lack thereof) of a taxpayer in an activity is not expected to change from year to year, although there will be instances in which it does change.

Limited partnerships

In the case of a limited partnership interest, except to the extent provided by regulations, it is conclusively presumed that the taxpayer has not materially participated in the activity. In general, under relevant State laws, a limited partnership interest is characterized by limited liability, and in order to maintain limited liability status, a limited partner, as such, cannot be active in the partnership's business. The presumption that a limited partnership interest is passive applies even when the taxpayer possesses the limited partnership interest indirectly through a tiered entity arrangement (e.g., the taxpayer owns a general partnership interest, or stock in an S corporation, and the partnership or corporation in which the taxpayer owns such interest itself owns a limited partnership interest in another entity).

When a taxpayer possesses both a limited partnership interest and another type of interest, such as a general partnership interest, with respect to an activity, except as otherwise provided in regulations, lack of material participation is conclusively presumed with respect to the limited partnership interest (thus limiting the use of deductions and credits allocable thereto). The presence of material participation for purposes of any other interests in the activity owned by the taxpayer is determined with reference to the relevant facts and circumstances.

Under the Act, the Secretary of the Treasury is empowered to provide through regulations that limited partnership interests in certain circumstances will not be treated (other than through the application of the general facts and circumstances test regarding material participation) as interests in passive activities. It is intended that this grant of authority be used to prevent taxpayers from manipulating the rule that limited partnerships generally are passive, in attempting to evade the passive loss provision.[29]

For example, the exercise of such authority by the Secretary may be appropriate in certain situations where taxpayers divide their interests in activities between limited and general partnership interests, e.g., to facilitate establishing a disposition of the taxpayer's entire interest in an activity, or in connection with special allocations of items of income, deduction, or credit as between limited and general partnership interests. The exercise of such authority by the Secretary would also be appropriate if taxpayers were permitted under State law to establish limited liability entities (that are not taxable as corporations) for personal service or other active businesses, and to denominate as "limited partnership interests" any interests in such businesses related to the rendering of personal services.[29A] The exercise of regulatory authority might also be appropriate where taxpayers sought to avoid limited partnership status with respect to substantially equivalent entities.

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[29] Examples of such evasion would include attempting to treat income that generally is regarded as not passive in nature (e.g., personal service income) as passive and accordingly as shelterable, or creating an unrealistically small separate "activity" in order to trigger suspended losses upon a partial disposition. Even absent the exercise of the Secretary's authority, items such as a guaranteed cash return or portfolio income from a limited partnership are not regarded as passive. Similarly, payments to a retiring partner under sec. 736 that are in the nature of income for past (or present) services, for example, are not regarded as passive.

Involvement in operations on a regular, continuous, and substantial basis

Outside of the limited partnership context, the presence or absence of material participation generally is to be determined with reference to all of the relevant facts and circumstances. In order to be treated as materially participating for purposes of the provision, the taxpayer must be involved in the operations of the activity on a regular, continuous, and substantial basis. This standard is based on the material participation standards under Code sections 1402(a) (relating to the self-employment tax) and 2032A (relating to valuation of farm property for purposes of the estate tax). However, the standard is modified consistently with the purposes of the passive loss provision.

Thus, precedents regarding the application of those preexisting legal standards, whether set forth in regulations, rulings, or cases, are not intended to be controlling with regard to the passive loss rule. For example, whether or not, under existing authorities interpreting sections 1402(a) and 2032A, it could be argued that the material participation requirement (for purposes of those sections) is in certain circumstances satisfied by periodic consultation with respect to general management decisions, the standard under this provision is not satisfied thereby in the absence of regular, continuous, and substantial involvement in operations.

In order to satisfy the material participation standard, the individual's involvement must relate to operations. Consider, for example, the case of a general partnership engaged in the business of producing movies. Among the services that may be necessary to this business are the following: writing screenplays; reading and selecting screenplays; actively negotiating with agents who represent writers, actors, or directors; directing, editing, scoring, or acting in the films; actively negotiating with third parties regarding financing and distribution; and actively supervising production (e.g., selecting and negotiating for the purchase or use of sets, costumes, etc.). An individual who does not make a significant contribution regarding these or similar services is not treated as materially participating. For example, merely approving a financing target, accepting a recommendation regarding selection of the screenplay, cast, locations, and director, or appointing others to perform the above functions, generally does not constitute involvement in operations.

In practice, a taxpayer is most likely to have materially participated in an activity for purposes of this provision in cases where involvement in the activity is the taxpayer's principal business. For example, an individual who spends 35 hours per week operating a grocery store, and who does not devote a comparable amount of

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[29A] Section 469(e)(3) provides in any event that earned income is not taken into account in computing income or loss from a passive activity.

time to any other business, clearly is materially participating in the business of the grocery store.

By contrast, when an activity is not an individual's principal business, it is less likely that the individual is materially participating. For example, an individual who works full-time as an employee or in a professional service business (such as law, accounting, or medicine), and who has also invested in a general partnership or S corporation engaged in a business involving orange groves, is unlikely to have materially participated in the orange grove business.

However, the fact that an activity is or is not an individual's principal business is not conclusive in determining material participation. An individual may materially participate in no business activities (e.g., someone who does not work or is retired), or in more than one business activity (e.g., a farmer who lives and works on his farm and "moonlights" by operating a gas station).

Another factor that may be highly relevant in showing regular, continuous, and substantial involvement in the operations of an activity, and thereby establishing material participation, is whether, and how regularly, the taxpayer is present at the place or places where the principal operations of the activity are conducted. For example, in the case of an employee or professional who invests in a horse breeding activity, if the taxpayer lives hundreds of miles from the site of the activity, and does not often visit the site, such taxpayer is unlikely to have materially participated in the activity. By contrast, an individual who raises horses on land that includes, or is close to, his primary residence, is more likely to have materially participated.

Again, however, this factor is not conclusive. For example, even if the taxpayer in the above example lived near the site of the horse breeding activity, or visited it on numerous occasions during the year, it would still be necessary for the taxpayer to demonstrate regular, continuous, and substantial involvement in the operations of the activity. Such involvement might be shown, for example, by hiring and from time to time supervising those responsible for taking care of the horses on a daily basis, along with making decisions (i.e., not merely ratifying decisions) regarding the purchase, sale, and breeding of horses.

Moreover, under some circumstances, an individual may materially participate in an activity without being present at the activity's principal place of business. In order for such a taxpayer materially to participate, however, the taxpayer still must be regularly, continuously, and substantially involved in providing services integral to the activity. For example, in the case of an investor in a barge that transports grain along the Mississippi River, one way of materially participating is regularly to travel with the barge (not merely as a passenger, but performing substantial services with respect to the transporting of grain). Another way of materially participating, without being present at the principal place of business, is to work on a regular basis at finding new customers for the barge service, and to negotiate with customers regarding the terms on which the service is provided. In the case of farming, Congress anticipated that an individual who does not perform physical work relating to a farm, but who is treated as having self-employment income with respect to the farm under section 1402, generally will be treated as materially participating.

In determining material participation, the performance of management functions generally is treated no differently than rendering other services or performing physical work with respect to the activity. However, a merely formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, does not constitute material participation.

For example, in the case of a cattle-feeding activity, the fact that an investor regularly receives and responds to "check-a-box" forms regarding when grain should be purchased, what the cattle should be fed, etc., may have little or no bearing on material participation. If the management decisions being made by the taxpayer are illusory (e.g., whether to feed the cattle or let them starve), or guided by an expert in the absence of any independent exercise of judgment by the taxpayer, or unimportant to the business,[30] they are given little weight. Similarly, in situations where the investor's assets are pooled with those of other investors (such as a cattle herd), the fact that the investor's decisions regarding management do not differ or differ only insubstantially from those of other investors is a factor indicating that the investor's involvement in the activity may not rise to the level of material participation.

The fact that a taxpayer has little or no knowledge or experience regarding the cattle-feeding business is highly significant in determining whether such taxpayer's participation in management is likely to amount to material participation. However, even if a taxpayer has such knowledge and experience, if he merely approves management decisions recommended by a paid advisor, the taxpayer's role is not substantial (and he accordingly has not materially participated), since the decisions could have been made without his involvement.

Even an intermittent role in management, while relevant, does not establish material participation in the absence of regular, continuous, and substantial involvement in operations. For example, the fact that one has responsibility for making significant management decisions with respect to an activity does not establish material participation, even if one from time to time exercises such responsibility. It is almost always true (disregarding special cases such as limited partnership interests) that the owner of an interest in an activity has some right to make management decisions regarding the activity, at least to the extent that his interest is not outweighed by that of other owners. Yet many individuals who possess significant ownership interests do not materially participate, and, under present law, have received tax benefits that Congress concluded should be subject to limitation under the passive loss rule.[31] Participation in management cannot be relied upon unduly

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[30] For example, management decisions may be unimportant to the business where the tax benefits from the business outweigh any risk of economic loss that may result from the decisions.

[31] Experience in applying existing legal standards confirms that a test based on participation in management is subject to manipulation and creates frequent factual disputes between taxpayers and the Internal Revenue Service. Sec. 464, for example, disallows prepaid expenses incurred in a farming activity if more than 35 percent of the loss from the activity is allocated to limited partners or persons who do not actively participate in management. As a result, farming

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both because its genuineness and substantiality are difficult to verify, and because a general management role, absent more, may fall short of the level of involvement that the material participation standard in the provision is meant to require. Nevertheless, it is likely that, despite the difficulty in many circumstances of ascertaining whether the management services rendered by an individual are substantial and *bona fide*, such services are likely to be so when the individual is rendering them on a full-time basis and the success of the activity depends in large part upon his exercise of business judgment.

The fact that an individual works full time in a line of business consisting of one or more business activities does not determine his material participation in a particular activity, although his work may rise to the level of material participation with respect to one or more of the activities. An individual's material participation in any activity is determined on the basis of his regular, continuous, and substantial involvement in the operations of the activity. His involvement in the operations of other activities is not determinative. Thus, for example, a taxpayer's material participation in a rental activity (which is treated as passive without regard to the taxpayer's material participation) does not affect his material participation, if any, in other activities.

A taxpayer is likely to be materially participating in an activity, if he does everything that is required to be done to conduct the activity, even though the actual amount of work to be done to conduct the activity is low in comparison to other activities.

Providing legal, tax, or accounting services as an independent contractor (or as an employee thereof), or that the taxpayer commonly provides as an independent contractor, would not ordinarily constitute material participation in an activity other than the activity of providing these services to the public. Thus, for example, a member of a law firm who provides legal services to a client regarding a general partnership engaged in research and development, is not, if he invests in such partnership, treated as materially participating in the research and development activity by reason of such legal services.

The fact that a taxpayer utilizes employees or contract services to perform daily functions in running the business does not prevent such taxpayer from qualifying as materially participating. However, the activities of such agents are not attributed to the taxpayer, and the taxpayer must still personally perform sufficient services to establish material participation.

A special rule, derived from section 2032A, applies with respect to farming activities, permitting taxpayers to qualify as materially participating in certain situations involving retired or disabled individuals who previously were materially participating (as that

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activities that rely upon syndication to outside investors, and that are operated principally under the direction of an agent, have been structured so as to assist otherwise passive investors in demonstrating that they play a role in management decisions. While the Internal Revenue Service may argue in any such instance that an investor is not truly participating in management, such argument may be difficult to sustain in the absence of reliable direct evidence regarding the investor's independence of judgment. Congress expects that the material participation standard for purposes of the passive loss rule, in light of its focus on the taxpayer's role in actual operations, will not be similarly subject to manipulation and ambiguity.

term is used for purposes of the passive loss rule), or involving a surviving spouse of an individual who was so participating. Thus, to the extent that, under section 2032A(b)(4) or (5), such person would be treated as still materially participating during retirement or disability (or, in the case of a surviving spouse, after the decedent's death), such person shall be treated as materially participating for purposes of the passive loss provision.

With respect to material participation in an agricultural activity, certain decision-making, if *bona fide* and undertaken on a regular, continuous, and substantial basis, may be relevant to material participation. The types of decision-making that may be relevant in this regard include, without being limited to, decision-making regarding (1) crop rotation, selection, and pricing, (2) the incursion of embryo transplant or breeding expenses, (3) the purchase, sale, and leasing of capital items, such as cropland, animals, machinery, and equipment, (4) breeding and mating decisions, and (5) the selection of herd or crop managers who then act at the behest of the taxpayer, rather than as paid advisors directing the conduct of the taxpayer.

The application of the material participation standard to a condominium hotel that is not a rental activity for purposes of the passive loss rules may be illustrated as follows. Assume that an individual who is an investor in the hotel does not live nearby, has a principal business that is unrelated to operating the hotel, is inexperienced in the hotel business, and employs agents to perform various essential hotel functions. However, such individual's participation in the hotel business involves making frequent visits to the hotel in order to conduct onsite inspections, meet with onsite management, and otherwise participate in integral functions of the business. In addition, the individual on a regular basis uses his independent discretion to make business decisions such as the following: (1) regularly establishing room rental rates, (2) establishing and reviewing hiring and other personnel policies, including review of management personnel, (3) reviewing and approving periodic and annually audited financial reports, (4) participating in budget operating costs and establishing capital expenditures, (5) establishing the need for and level of financial reserves, (6) selecting the banking depository for rental proceeds and reserve funds, (7) participating in frequent meetings at the hotel to review operations and the business plan, and (8) assisting in offsite business promotion activities. The individual is personally assessed his owner association charges and personally pays them, is assessed separately and personally the property taxes against his room or rooms, must personally appeal his assessment if he thinks it incorrect, and personally pays any debt service on his unit when due.

Under these circumstances, if the standard requiring regular, continuous, and substantial involvement is satisfied, then the taxpayer is treated as materially participating in the hotel activity. He is not so treated, however, in the absence of sufficient involvement. No safe harbor should be inferred from the preceding paragraph. For example, if the taxpayer's role in any of the above respects was limited to pro forma ratification of decisions made by management agents, that would tend to rebut material participation. Merely approving decisions made by others does not satisfy the standard.[32]

Material participation by a corporation subject to the passive loss rule

Special rules apply in the case of corporations that are subject to the passive loss rule. A corporation that is subject to the passive loss provision is treated as materially participating in an activity with respect to which one or more shareholders, owning in the aggregate more than 50 percent of the outstanding stock of the corporation, materially participate. Thus, for example, a corporation with 5 shareholders, each owning 20 percent of the stock, is treated as materially participating in an activity if three or more of such shareholders so participate. If one of the three shareholders who so participated owned only 5 percent of the stock, and as a result the three participating shareholders owned only 45 percent of the stock in the corporation, the corporation would not be treated as materially participating in the activity.[33]

A closely held C corporation subject to the passive loss provision that is not a personal service corporation (as defined for purposes of the provision) may also be treated as materially participating in an activity if it meets the standard set forth in section 465(c)(7)(C), disregarding clause (iv). This standard generally is satisfied if (i) for the prior 12-month period, at least one full-time employee of the corporation provided sufficient services in active management with respect to the activity, (ii) during the same period, at least 3 full-time nonowner employees provided sufficient services directly related to the activity, and (iii) the amount of business deductions by the taxpayer attributable to the activity exceeded 15 percent of gross income from the activity for the taxable year.

Active participation in a rental real estate activity

Allowance of $25,000 of losses and credits against other income under specified circumstances

For purposes of the passive loss provision, rental activities are treated as passive without regard to whether the taxpayer materially participates. The reasons for this rule are specified above in the section entitled "Reasons for Change."

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[32] *See* 132 Cong. Rec. S8244-46 (June 24, 1986) and S13958 (September 27, 1986) (colloquies between Senators Packwood and Hatfield).

[33] No special rule is provided for determining material participation by a trust. Prior and present law provide that, generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint venture for the conduct of business for profit (Treas. Reg. sec. 301.7701-4). A trust may be treated as an association taxable as a corporation, for tax purposes, if it is a joint enterprise for the conduct of business for profit. Thus, it is unlikely that a trust as such for Federal income tax purposes will be materially participating in a trade or business activity, within the meaning of the passive loss rule. In the case of a grantor trust, to the extent the grantor or beneficiary is treated as the owner for tax purposes (sec. 671), the material participation of the person treated as the owner is relevant to the determination of whether income or loss from an activity owned through the grantor trust is treated as passive in the hands of the owner. Similarly, in the case of a qualified electing Subchapter S trust (sec. 1361(d)(1)(B)) that is treated as a grantor trust (i.e., the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S corporation's activity is a passive activity with respect to the beneficiary.

In the case of rental real estate, however, some specifically targeted relief has been provided because rental real estate is held, in many instances, to provide financial security to individuals with moderate incomes. In some cases, for example, an individual may hold for rental a residence that he uses part time, or that previously was and at some future time may be his primary residence. Even absent any such residential use of the property by the taxpayer, Congress believed that a rental real estate investment in which the taxpayer has significant responsibilities with respect to providing necessary services, and which serves significant nontax purposes of the taxpayer, is different in some respects from the activities that are meant to be fully subject to limitation under the passive loss provision.[34]

Under the relief provision for rental real estate, an individual may offset up to $25,000 of income that is not treated as passive, by using losses and credits from rental real estate activities with respect to which such individual actively participates.[35] (Low-income housing and rehabilitation credits can be so used on a deduction-equivalent basis, as a part of the overall $25,000 amount, whether or not the individual actively participates in the rental real estate activity to which such credits relate.) This relief applies only if the individual does not have sufficient passive income for the year, after considering all other passive deductions and credits, to use fully the losses and credits from such rental real estate activities. No relief is provided under the provision to taxpayers other than individuals (e.g., to trusts, personal service corporations, or closely held C corporations subject to the passive loss provision),[36] except for a special 2-year rule for estates, discussed in Section 1, above.

The $25,000 amount is reduced, but not below zero, by 50 percent of the amount by which the taxpayer's adjusted gross income for the year exceeds $100,000 ($200,000 in the case of low-income housing and rehabilitation credits). In the case of a married individual not filing a joint return, no more than $12,500 of such relief is available, reduced by 50 percent of the amount by which such individual's adjusted gross income exceeds $50,000. For these purposes, adjusted gross income is determined without reference to net losses from passive activities (other than losses allowable solely by reason of a fully taxable disposition of an activity).

Since relief under this rule applies only to rental real estate activities, it does not apply to passive real estate activities that are not treated as rental activities under the provision (e.g., an interest in the activity of operating a hotel). Similarly, relief is not provided with regard to the renting of property other than real estate (e.g., equipment leasing).

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[34] For example, in the case of a rental real estate investor whose cash expenses with respect to the investment (e.g., mortgage payments, condominium or management fees, and costs of upkeep) exceed cash inflows (i.e., rent), tax losses other than those relating to depreciation may not be providing any cash flow benefit.

[35] For purposes of applying this standard, as with respect to material participation, services performed both by the taxpayer and by the taxpayer's spouse are considered (whether or not such individuals file a joint return). It is worth noting that, while standards requiring active management or active participation in management apply for certain purposes under prior law (see secs. 55(e), 464(e)(2)(b), and 2032A), these standards are not the same as the active participation standard described herein.

[36] *See Overview, supra.*

Scope of active participation

A taxpayer is treated as not having actively participated in a rental real estate activity if the taxpayer (in conjunction with such taxpayer's spouse, even in the absence of a joint return) owns less than 10 percent (by value) of all interests in such activity at any time during the year (or shorter relevant period of ownership).[37] This requirement is designed to assist in restricting the relief provided under the $25,000 rule (assuming all other applicable requirements are met) to appropriate circumstances—for example, the case of a home in which the taxpayer formerly lived or plans subsequently to live, as opposed to a syndicated real estate shelter. In addition, the 10 percent rule reflects the fact that active participation by a less than 10 percent owner typically represents services performed predominantly with regard to ownership interests of co-owners.

In the case of a taxpayer owning an interest in a rental real estate activity and meeting the 10-percent ownership requirement, up to $25,000 of relief may be available if the taxpayer actively participates in the activity. This standard is designed to be less stringent than the material participation requirement, in light of both the special nature of rental activities, which generally require less in the way of personal services, and the Congress' reasons for providing up to $25,000 of relief in this instance.

The difference between active participation and material participation is that the former can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and *bona fide* sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

Thus, for example, a taxpayer who owns and rents out an apartment that formerly was his primary residence, or that he uses as a part-time vacation home, may be treated as actively participating even if he hires a rental agent and others provide services such as repairs. So long as the taxpayer participates in the manner described above, a lack of material participation in operations does not lead to the denial of relief.

A limited partner, to the extent of his limited partnership interest, is treated as not meeting the active participation standard.[38] In addition, a lessor under a net lease is unlikely to have the degree of involvement which active participation entails. Moreover, as with regard to the material participation standard, services provided by an agent are not attributed to the principal, and a merely formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, is insufficient.

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[37] Since low-income housing and rehabilitation credits are allowable without regard to active participation, they are unaffected by this requirement.

[38] The active participation rules do not prevent a limited partner from receiving $25,000 of benefit with regard to the low-income housing or rehabilitation credit, since relief relating to such credits does not depend upon active participation.

In this regard, it is useful to compare the above example of a taxpayer who owns and rents out an apartment that formerly was his primary residence with a tax shelter investor. The former taxpayer, even if he hires a rental agent and uses contract or other services to handle day-to-day problems such as routine repairs, still is likely to participate actively in light of the fact that he likely is not using it principally to generate tax losses.

By contrast, consider the case of a taxpayer who purchases an undivided interest in a shopping mall. The taxpayer purchased his interest from a promoter, based on a prospectus describing the investment opportunity and stressing the tax benefits of the $25,000 rule. Since one of the taxpayer's principal interests in the investment is to shelter income, he relies on a professional management company which also holds an interest in the shopping mall to make all significant management decisions. In order to create an evidentiary record purporting to show active participation, the management company sends letters to the investor detailing operating expenses, changes in tenants and new lease terms. The management company also informs the investor as to market trends, and requests approval of decisions to seek certain types of retailers as tenants. The investor ratifies such judgments without independently exercising judgment. The investor has not actively participated in the activity.

5. Definition of activity

In applying the passive loss rule, one of the most important determinations that must be made is the scope of a particular activity. This determination is important for several reasons. For example, if two undertakings are part of the same activity, the taxpayer need only establish material participation with respect to the activity as a whole, whereas if they are separate activities he must establish such participation separately for each. In the case of a disposition, knowing the scope of the activity is critical to determining whether the taxpayer has disposed of his entire interest in the activity, or only of a portion thereof.[39]

Defining separate activities either too narrowly or too broadly could lead to evasion of the passive loss rule. For example, an overly narrow definition would permit taxpayers to claim losses against salary, portfolio, or active business income by selectively disposing of portions of their interests in activities with respect to which there has been depreciation or loss of value, while retaining any portions with respect to which there has been appreciation. An overly broad definition would permit taxpayers to amalgamate undertakings that in fact are separate, and thus to use material participation in one undertaking as a basis for claiming without limitation losses and credits from another undertaking.

The determination of what constitutes a separate activity is intended to be made in a realistic economic sense. The question to be answered is what undertakings consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss.

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[39] Determining the scope of an activity also is important with respect to the 10 percent ownership requirement for actively participating in a rental real estate activity, and in certain situations where the taxpayer disposes of an activity other than through a taxable transaction.

Section 183, relating to hobby losses, involves issues similar to those arising with respect to passive losses.[40] Section 183 requires that separate activities be identified in order to determine whether a specific activity constitutes a hobby. Treasury Regulations interpreting this provision note that all facts and circumstances of a specific case must be taken into account, and then identify as the most significant facts and circumstances: "the degree of organizational and economic interrelationship in various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together . . . and the similarity of the various undertakings." These facts and circumstances likewise are relevant to determining the scope of an activity for purposes of the passive loss rule.[41]

In general, providing two or more substantially different products or services involves engaging in more than one activity (unless customarily or for business reasons provided together—e.g., the appliance and clothing sections of a department store). For example, operating a restaurant and engaging in research and development are objectively so different that they are extremely unlikely to be part of the same activity. In addition, different stages in the production and sale of a particular product that are not carried on in an integrated fashion generally are not part of the same activity. For example, operating a retail gas station and engaging in oil and gas drilling generally are not part of the same activity. In general, normal commercial practices are highly probative in determining whether two or more undertakings are or may be parts of a single activity.

On the other hand, the fact that two undertakings involve providing the same products or services does not establish that they are part of the same activity absent the requisite degree of economic interrelationship or integration. For example, separate real estate rental projects built and managed in different locations by a real estate operator generally will constitute separate activities. Similarly, in the case of farming, each farm generally will constitute a separate activity. On the other hand, an integrated apartment project or shopping center generally will be treated as a single activity.

Separate research and development projects may constitute separate activities in the absence of a sufficient interrelationship between the activities (e.g., with regard to personnel, facilities used, or the common use of knowhow developed in specific undertakings). When sufficient interrelationship exists, however, the projects are part of the same activity. For example, if a particular research project is terminated, but knowhow developed from the project contributes to a subsequent project, it may be inaccurate to view the termination as establishing a loss. Any economic success realized by the second project may be attributable in part to amounts spent on the first project, and thus may establish that such amounts were not lost upon termination.

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[40] By contrast, the at-risk rules, to the extent that they define "activity," address issues different from those that are relevant with respect to passive losses. *See* sec. 465(c)(2). The at-risk rules define "activity" in terms of narrow asset units, such as individual items of property, in light of the goal of such rules to establish a relationship between each such asset and financing attributable to it. In the passive loss context, unlike the at-risk context, financing is not the relevant issue.

[41] *See* Treas. Reg. sec. 1.183-1(d)(1). The provision in this regulation that a taxpayer's characterization of what constitutes an activity will be accepted unless it is unduly "artificial" does not apply with respect to the passive loss rule. While the Congress anticipated that artificial characterizations will be disregarded as a matter of course with respect to passive losses, there is no presumption that the taxpayer's characterization is correct even absent such "artificiality.

Certain types of integration among undertakings are not sufficient to establish that they are part of the same activity. For example, the fact that the taxpayer has ultimate management responsibilities with respect to different undertakings does not establish that they are part of the same activity, nor does the fact that the undertakings have access to common sources of financing, or benefit for goodwill purposes from sharing a common name. These common features may often be shared by all of the undertakings in which a particular individual is engaged, without establishing, in a substantial economic sense, that all such undertakings are part of the same activity.

The fact that two undertakings are conducted by the same entity (such as a partnership or S corporation) does not establish that they are part of the same activity. Conversely, the fact that two undertakings are conducted by different entities does not establish that they are different activities. Rather, the activity rules generally are applied by disregarding the scope of passthrough entities such as partnerships and S corporations.

With respect to limited partnerships, an additional rule applies in light of the special status of limited partnership interests with respect to material participation. An interest in a limited partnership is not treated as being part of the same activity as any activity in which the taxpayer is treated as materially participating. However, when otherwise appropriate, a limited partnership interest is treated as part of a larger activity in which the taxpayer does not materially participate (e.g., when two limited partnerships are conducting the same activity, or an individual is both a limited partner and a nonparticipating general partner with respect to the same activity).[42]

In applying the facts and circumstances test regarding what constitutes an activity, any undertaking that is accorded special treatment under the passive loss rule (e.g., treatment as always being active or as always being passive) is not treated as part of the same activity as any undertaking that does not receive identical treatment under the passive loss rule. For example, providing services as an employee or in a personal service business intrinsically is not passive, without requiring the examination of further facts and circumstances. Thus, such an undertaking generally is not part of the same activity as an undertaking in which further facts and circumstances must be examined. An oil and gas working interest is treated as not passive without regard to material participation, and thus is treated as separate from any undertaking not relating to oil and gas working interests.[43] This rule is necessary so that the special rules for particular undertakings will not in effect be extended to other types of undertakings (e.g., through the argument that an undertaking that is not a working interest is part of the same activity as a working interest, and hence should not be treated as passive even in the absence of material participation).

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[42] These special rules regarding limited partnership interests do not apply in the case of any such interest that, pursuant to the Secretary's special regulatory authority, is treated as not intrinsically passive (i.e., as passive only to the extent established by examination of the relevant facts and circumstances).

6. Rental activity

In general

Under the passive loss rule, a rental activity is generally treated as a passive activity regardless of whether the taxpayer materially participates in the activity. Deductions and credits from a rental activity generally may be applied to offset only other income from passive activities. In the case of rental real estate activities in which the taxpayer actively participates, a special rule permits the application of losses and credits from the activity against up to $25,000 of non-passive income of the taxpayer, for individual taxpayers. A taxpayer is not considered to actively participate in the activity if he owns less than a 10 percent interest in it at any time during the year (or relevant shorter period of ownership).

In determining what is a rental activity for purposes of these rules, prior law applicable in determining when an S corporation had passive rental income, as opposed to active business income, for purposes of continuing to qualify as an S corporation, provides a useful analogy.[44] The purpose of the prior law rule, like the passive loss rule, is to distinguish between rental activity that is passive in nature and nonrental activity which may not be passive. Thus, under the passive loss rule, a rental activity generally is an activity, the income from which consists of payments principally for the use of tangible property, rather than for the performance of substantial services.[45]

Some activities are not treated as rental activities under the passive loss rule even though they may involve the receipt of payments for the use of tangible property, because significant services are rendered in connection with such payments. Payments for the use of tangible property for short periods, with heavy turnover among the users of the property, may cause an activity not to be a rental activity, especially if significant services are performed in connection with each new user of the property. Another factor indicating that an activity should not be treated as a rental activity is that expenses of day-to-day operations are not insignificant in relation to rents produced by the property, or in relation to the amount of depreciation and the cost of carrying the rental property.

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[43] *See* sec. 6, *infra*, noting that, for the same reasons, a rental real estate undertaking, as well as a rental undertaking involving property other than real estate, each is treated as not part of the same activity as any other type of undertaking.

[44] Sec. 1372(e)(5) (as in effect prior to the Subchapter S Revision Act of 1982) applied principles that are relevant in determining whether significant services are performed in connection with furnishing property. For example, regulations applicable in interpreting that section provided that rents did not include payments for the use or occupancy of rooms where significant services were also rendered to the occupant (such as hotels and the like which furnish hotel services). The regulations further provided, "services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat, light, . . . the collection of trash, etc., are not considered as services rendered to the occupant.

[45] A rental activity generally does not include payments for the use of intangible property (e.g., stocks), or other payments more properly characterized as interest (e.g., for the use or forbearance of money).

On the other hand, although the period for which property is rented is not in itself determinative of whether the activity is a rental activity, a long-term rental period (in comparison to the useful life of the property) and low turnover in the lessees of the property, is indicative that the activity is a rental activity.

For example, an activity consisting of the short-term leasing of motor vehicles, where the lessor furnishes services including maintenance of gas and oil, tire repair and changing, cleaning and polishing, oil changing and lubrication and engine and body repair, is not treated as a rental activity. By contrast, furnishing a boat under a bare boat charter, or a plane under a dry lease (i.e., without pilot, fuel or oil), constitutes a rental activity under the passive loss rule, because no significant services are performed in connection with providing the property.

Based on similar considerations, renting hotel rooms or similar space used primarily for lodging of transients where significant services are provided generally is not a rental activity under the passive loss rule. By contrast, renting apartments to tenants pursuant to leases (with, e.g., month-to-month or yearly lease terms) is treated as a rental activity. Similarly, being the lessor of property subject to a net lease is a rental activity.

A rental activity may include the performance of services that are incidental to the activity (e.g., a laundry room in a rental apartment building). However, if a sufficient amount of such services are rendered, they may rise to the level of a separate activity, or the entire activity may not constitute a rental activity under the provision (e.g., a hotel).

Scope of rental activity

Some businesses involve the conduct of rental activities in association with other activities not involving renting tangible property. Although the other activities may immediately precede the rental activity, be conducted by the same persons, or take place in the same general location, they are not treated as a part of the rental activity, because under the passive loss rule rental activities are considered passive activities without regard to the taxpayer's material participation. In the case of other activities, an examination of the taxpayer's material participation generally determines whether an activity is passive. Rental activities generally are treated as separate from nonrental activities involving the same persons or property. Thus, for example, automobile leasing is treated as a different activity from automobile manufacturing, and real estate construction and development is a different activity from renting the newly constructed building.

Similarly, suppose a travel agency operated in the form of a general partnership has its offices on three floors of a 10-story building that it owns. The remainder of the space in the building is rented out to tenants. The travel agency expects to take over another floor for its own use in a year. The partnership is treated as being engaged in two separate activities: a travel agency activity and a rental real estate activity. Deductions and credits attributable to the building are allocable to the travel agency activity only to the extent that they relate to the space occupied by the travel agency during the taxable year.

Separate rental real estate activity

Because only rental real estate activities are eligible for the $25,000 offset of losses and credits against non-passive income, a rental real estate undertaking is not considered as part of the same activity as any undertaking other than another rental real estate undertaking. For these purposes, the word "rental" is interpreted consistently with its meaning in other respects for purposes of the passive loss provision. Thus, for example, a hotel is treated neither as a rental real estate undertaking, nor as consisting of two activities only one of which is a rental real estate undertaking.

To be eligible for the $25,000 offset, a taxpayer must actively participate in the rental real estate activity. He is not considered to actively participate unless he has at least a 10 percent interest in the activity, because without a significant ownership interest his participation in the activity is likely to be for the benefit of other owners. For purposes of determining whether his interest in the activity amounts to at least 10 percent, separate buildings are treated as separate rental real estate activities if the degree of integration of the business and other relevant factors do not require treating them as parts of a larger activity (e.g., an integrated shopping center).

In the case of units smaller than an entire building, it similarly is necessary to assess the degree of business and functional integration among the units in determining whether they are separate activities. A cooperative apartment in an apartment building, owned by a taxpayer unrelated to those owning the other apartments in the building, generally will qualify as a separate activity, despite the fact that ownership of the building may be shared with owners of other apartments in the building, and despite the sharing with other apartments of such services as management and maintenance of common areas. By contrast, ownership of an undivided interest in a building, or of an area too small to be rented as a separate unit (or that is not rented as a separate unit) does not qualify as a separate activity.

In the case of a commercial building, for example, that is rented out to various tenants, and in which different parties own different floors, it again is necessary to examine the degree of integration with which business relating to different floors is conducted. An arrangement in which the rights to the various floors are separately sold to different parties, but rental of the building is handled in a centralized fashion, generally constitutes a single activity, whereas such treatment might not be appropriate if the owners of different floors separately manage their own rental businesses.

7. Working interest in oil and gas property

When a taxpayer owns a working interest in an oil and gas property, the working interest is not treated as a passive activity, whether or not the taxpayer materially participates. Thus, losses and credits derived from such activity can be used to offset other income of the taxpayer without limitation under the passive loss rule.

In general, a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property.[46] Rights to overriding royalties, production payments, and the like, do not constitute working interests, because they are not burdened with the responsibility to share expenses of drilling, completing, or operating oil and gas property. Similarly, contract rights to extract or share in oil and gas, or in profits from extraction, without liability to share in the costs of production, do not constitute working interests. Income from such interests generally is considered to be portfolio income.

A working interest generally has characteristics such as responsibility for signing authorizations for expenditures with respect to the activity, receiving periodic drilling and completion reports, receiving periodic reports regarding the amount of oil extracted, possession of voting rights proportionate to the percentage of the working interest possessed by the taxpayer, the right to continue activities if the present operator decides to discontinue operations, a proportionate share of tort liability with respect to the property (e.g., if a well catches fire), and some responsibility to share in further costs with respect to the property in the event that a decision is made to spend more than amounts already contributed.

However, the fact that a taxpayer is entitled to decline, or does decline, to make additional contributions under a buyout, nonparticipation, or similar arrangement, does not contradict such taxpayer's possessing a working interest. In addition, the fact that tort liability may be insured against does not contradict such taxpayer's possessing a working interest.

When the taxpayer's form of ownership limits the liability of the taxpayer, the interest possessed by such taxpayer is not a working interest for purposes of the passive loss provision. Thus, for purposes of the passive loss rules, an interest owned by a limited partnership is not treated as a working interest with regard to any limited partner, and an interest owned by an S corporation is not treated as a working interest with regard to any shareholder.[47] The same result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S corporation, even if different in form.

When an interest is not treated as a working interest because the taxpayer's form of ownership limits his liability, the general rules regarding material participation apply to determine whether the interest is treated as in a passive activity. Thus, for example, a limited partner's interest generally is treated as in a passive activity. In the case of a shareholder in an S corporation, the general facts and circumstances test for material participation applies and the working interest exception does not apply, because the form of ownership limits the taxpayer's liability.

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[46] *See* Treas. Reg. sec. 1.612-4(a), along with cases and rulings decided thereunder, such as *Phillips* v. *Comm'r* 233 F. Supp. 59 (E.D. Tex. 1964), aff'd. *per curiam*, (5th Cir.), 66-1 U.S.T.C. Paragraph 9157; *Haass* v. *Comm'r*, 55 T.C. 43 (1970), *acq.*, 1971-2 C.B. 2; *Cottingham* v. *Comm'r*, 63 T.C. 695 (1975); *Miller* v. *Comm'r* 78-1 U.S.T.C. paragraph 9127 (C.D. Cal. 1977); Rev. Rul. 68-139, 1968-1 C.B. 311.

[47] However, the fact that an interest is not treated as a working interest for purposes of the passive loss rules due to the taxpayer's form of ownership has no effect on whether it qualifies as a working interest for any other purpose under the Internal Revenue Code.

In determining whether the taxpayer's form of ownership limits his liability, the rule described in the two prior paragraphs is applied by looking through tiered entities. For example, a general partner in a partnership that owns a limited partnership interest in a partnership that owns a working interest is not treated as owning a working interest.

A special rule applies in any case where, for a prior taxable year, net losses from a working interest in a property were treated by the taxpayer as not from a passive activity. In such a case, any net income realized by the taxpayer from the property (or from any substituted basis property, e.g., property acquired in a sec. 1031 like-kind exchange for such property) in a subsequent year also is treated as active. Under this rule, for example, if a taxpayer claims losses for a year with regard to a working interest and then, after the property to which the interest relates begins to generate net income, transfers the interest to an S corporation in which he is a shareholder, or to a partnership in which he has an interest as a limited partner, his interest with regard to the property continues to be treated as not passive.[48]

Under some circumstances, deductions relating to a working interest may be subject to limitation under other provisions in the Internal Revenue Code. For example, protection against loss through nonrecourse financing, guarantees, stop-loss agreements or other similar arrangements, may cause certain deductions allocable to the taxpayer to be disallowed under section 465. Such limitations are applied prior to and independently of the passive loss rule.

Effective Date

The passive loss rule is effective in taxable years beginning on or after January 1, 1987. It applies to all passive activity losses incurred in taxable years beginning on or after that date, and to passive activity credits for property placed in service in taxable years beginning on or after that date. However, in the case of certain pre-enactment interests, the rule is phased in. The amount disallowed under the passive loss provision during any year in the transitional period cannot exceed the applicable percentage of the amount that would be disallowed for that year under the provision if fully effective. The applicable percentage is 35 percent for 1987, 60 percent for 1988, 80 percent for 1989, 90 percent for 1990, and 100 percent for 1991 and thereafter.

Interests in passive activities acquired by the taxpayer on or before the date of enactment of the Act (October 22, 1986) are eligible for the phase-in of the passive loss rule. Interests in activities acquired after October 22, 1986, however, are not eligible for the phase-in, but rather are fully subject to the passive loss rule.

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[48] This rule applies whether or not the working interest would have been treated as passive in the absence of the provision treating working interests as *per se* active, i.e., if material participation were relevant in this context.

The Congress intended that a contractual obligation to purchase an interest in a passive activity that is binding on October 22, 1986 be treated as an acquisition of the interest in the activity for this purpose. A binding contract qualifies under this rule, even if the taxpayer's obligation to acquire an interest is subject to contingencies, so long as the contingencies are beyond the reasonable control of the taxpayer. Thus, if the taxpayer has, by October 22, 1986, signed a subscription agreement to purchase a limited partnership interest contingent upon the agreement of other purchasers to acquire interests in the limited partnership amounting to a particular total, then if the contingency is satisfied, he is eligible for the phase-in rule with respect to the interest he was contractually bound to acquire. On the other hand, a conditional obligation to purchase, or one subject to contingencies within the taxpayer's control, does not give rise to eligibility under the phase-in rule.

In the case where, after October 22, 1986, investors in an activity contribute additional capital to the activity, their interests still qualify in full for relief under the phase-in to the extent that their percentage ownership interests do not change as a result of the contribution. However, if a taxpayer's ownership interest is increased after October 22, 1986, then (except to the extent the increase in the taxpayer's interest arises pursuant to a pre-October 23, 1986 binding contract or partnership agreement), the portion of his interest attributable to such increase does not qualify for the phase-in relief. For example, if a taxpayer, after October 22, 1986, increases his ownership interest in a partnership from 25 percent to 50 percent, then only the losses attributable to the 25 percent interest held prior to October 23, 1986 will qualify for transitional relief.[49]

In general, in order to qualify for phase-in relief, the interest acquired by a taxpayer must be in an activity which has commenced by October 22, 1986. For example, a rental activity has commenced when the rental property has been placed in service in the activity. When an entity in which the taxpayer owns an interest liquidates or disposes of one activity and commences another after October 22, 1986, the new activity does not qualify for phase-in relief. In the case of property purchased for personal use but converted to business use (e.g., a home that the taxpayer converts to rental use), similar rules apply. The activity qualifies for phase-in relief if it commences by October 22, 1986. In the case of a residence converted to rental use, for example, the residence must be held out for rental by October 22, 1986.

However, in the case of an activity that has not commenced by October 22, 1986, phase-in treatment nevertheless applies if the entity (or an individual owning the activity directly) has entered into a binding contract effective on or before August 16, 1986, to acquire the assets used to conduct the activity. Similarly, phase-in treatment applies in the case of self-constructed business property of an entity (or direct owner), where construction of the property to be used in the activity has commenced on or before August 16, 1986.

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[49] Phase-in relief applies only with respect to the percentage interest held by the taxpayer at all times after October 22, 1986. Thus, for example, if a taxpayer after October 22, 1986 reduces his interest in an activity from 50 percent to 25 percent, and subsequently purchases additional interests restoring his share to 50 percent, then only the 25 percent share held throughout qualifies for phase-in relief after such subsequent purchase.

In the case of a taxpayer owning both pre-October 23, 1986 and post-October 22, 1986 interests in passive activities, it is necessary to calculate the amount of passive loss qualifying for the phase-in. In order to determine this amount, it is necessary first to determine the amount that would be disallowed absent the phase-in. Phase-in relief then applies to the lesser of the taxpayer's total passive loss, or the passive loss taking into account only pre-enactment interests. Thus, for example, if a taxpayer has $100 of passive loss relating to pre-October 23, 1986 interests that would be disallowed in the absence of the phase-in, and has $60 of net passive income from post-October 22, 1986 interests, resulting in a total passive loss of $40, then the phase-in treatment applies to the lesser of $100 or $40 (i.e., $40). For purposes of this rule, the pre-October 23, 1986 and post-October 22, 1986 losses are calculated by including credits, in a deduction-equivalent sense.

Under the Act, any passive loss that is disallowed for a taxable year during the phase-in period and carried forward is allowable in a subsequent year only to the extent that there is net passive income in the subsequent year (or there is a fully taxable disposition of the activity).

For example, assume that a taxpayer has a passive loss of $100 in 1987, $65 of which is allowed under the applicable phase-in percentage for the year and $35 of which is carried forward. Such $35 is not allowed in part in a subsequent year under the phase-in percentage applying for such year. If the taxpayer has a passive loss of $35 in 1988, including the amount carried over from 1987, then no relief under the phase-in is provided. If the taxpayer has a passive loss of $50 in 1988 (consisting of the $35 from 1987 and $15 from 1988, all of which is attributable to pre-October 23, 1986 interests), then $6 of losses (40 percent of the $15 loss arising in 1988) is allowed against active income under the phase-in rule. The $35 loss carryover from 1987 is disallowed in 1988 and is carried forward (along with the disallowed $9 from 1988) and allowed in any subsequent year in which the taxpayer has net passive income.

The applicable phase-in percentage applies to the passive loss net of any portion of such loss that may be allowed against non-passive income under the $25,000 rule.

Transition relief is provided in the case of low-income housing activities. Losses from certain investments after 1983 in low income housing are not treated as from a passive activity, applicable for a period of up to 7 years from the taxpayer's original investment.[50]

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $753 million in 1987, $3,008 million in 1988, $4,831 million in 1989, $6,811 million in 1990, and $8,003 million in 1991.

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[50] *See*, 132 Cong. Rec. E3392, October 2, 1986 (statement of Mr. Rostenkowski).

B. Extension of At-Risk Rules to Real Estate Activities (sec. 503 of the Act and sec. 465 of the Code)[51]

Prior Law

Loss limitation rules

Prior and present law (Code sec. 465) provide an at-risk limitation on losses from business and income-producing activities other than real estate and certain corporate active business activities, applicable to individuals and to certain closely held corporations.[52] The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity.

Under the loss limitation at-risk rules applicable to activities other than the holding of real property under prior and present law, a taxpayer's deductible losses from an activity for any taxable year are limited to the amount the taxpayer has placed at risk (i.e., the amount the taxpayer could actually lose) in the activity. The initial amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity; (2) the adjusted basis of other property contributed to the activity; and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged as security for repayment property not used in the activity. This amount is generally increased each year by the taxpayer's share of income and is decreased by the taxpayer's share of losses and withdrawals from the activity.

In the case of activities other than holding real property, a taxpayer is generally not considered at risk with respect to borrowed amounts if (1) the taxpayer is not personally liable for repayment of the debt (nonrecourse loans); or (2) the lender has an interest (other than as a creditor) in the activity (except to the extent provided in Treasury regulations). The taxpayer is also not considered at risk with respect to amounts for which the taxpayer is protected against loss by guarantees, stop-loss arrangements, insurance (other than casualty insurance) or similar arrangements. Losses which may not be deducted for any taxable year because of the loss limitation at-risk rule may be deducted in the first succeeding year in which the rule does not prevent the deduction.

The loss limitation at-risk rule for activities other than holding real property under prior and present law is applicable to individuals and to closely held corporations more than 50 percent in value of the stock in which was owned, at any time during the last half of the taxable year, by or for 5 or fewer individuals. Stock ownership is generally determined according to the rules applicable for purposes of identifying a personal holding company (sec. 542(a)(2)). In the case of a partnership or S corporation, the rules apply at the partner or shareholder level respectively.

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[51] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 401; H.Rep. 99-426, pp. 292-295; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1411; S.Rep. 99-313, pp. 747-751; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 134-136 (Conference Report).

[52] The Tax Reform Act of 1976 (P.L. 94-455) applied the at-risk rule to four specific activities: (1) holding, producing, or distributing motion picture films or video tapes; (2) farming; (3) leasing of personal property; and (4) exploring for, or exploiting, oil and natural gas resources. The Revenue Act of 1978 (P.L. 95-600) extended the rule to all activities except real estate and certain equipment leasing engaged in by closely held corporations. The Deficit Reduction Act of 1984 (P.L. 98-369) created an exception for certain active businesses of closely held C corporations.

Generally, a taxpayer's amount at risk is separately determined with respect to separate activities. Nevertheless, activities are treated as one activity (i.e., aggregated) if the activities constitute a trade or business and (1) the taxpayer actively participates in the management of that trade or business, or (2) in the case of a trade or business carried on by a partnership or S corporation, 65 percent or more of losses is allocable to persons who actively participate in the management of the trade or business. Authority is provided to prescribe regulations under which activities are aggregated or treated as separate activities.[53] In addition, an exception from the at-risk rules is provided for certain active business activities of closely held corporations, and for this purpose, the component members of an affiliated group are treated as a single taxpayer (sec. 465(c)(7)(F)).

Investment tax credit rules

Prior law also provided rules requiring the taxpayer to be at-risk with respect to property in order to qualify for the investment tax credit (sec. 46(c)(8)). These rules provided an exception where the property is financed by certain third party nonrecourse loans.

The investment tax credit at-risk rules limited the credit base of property used in an activity that was subject to the loss limitation at-risk rules, and generally provided that nonrecourse debt was treated as an amount at risk for investment credit purposes where (1) it was borrowed from an unrelated commercial lender, or represented a loan from or was guaranteed by certain governmental entities; (2) the property was acquired from an unrelated person; (3) the lender was unrelated to the seller; (4) the lender or a related person did not receive a fee with respect to the taxpayer's investment in the property; (5) the debt was not convertible debt; and (6) the nonrecourse debt did not exceed 80 percent of the credit base of the property.

Reasons for Change

Congress concluded that it is appropriate to apply the at-risk rules to real estate activities so as to limit the opportunity for overvaluation of property (resulting in inflated deductions), and to prevent the transfer of tax benefits arising from real estate activities to taxpayers with little or no real equity in the property.

The Act therefore extends the at-risk rules to real estate, with an exception for certain nonrecourse financing provided by organizations in the business of lending.

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[53] Similar rules apply in the case of activities described in sec. 465(c)(2)(A) (which includes certain motion picture, farming, leasing, oil and gas and geothermal deposit activities).

Nonrecourse financing by the seller of real property or a promoter (or a person related to either the seller or promoter) is not treated as an amount at risk under the Act, because there may be little or no incentive to limit the amount of such financing to the value of the property. In the case of third party commercial financing secured solely by the real property, however, the lender is much less likely to make loans which exceed the property's value or which cannot be serviced by the property; it is more likely that such financing will be repaid and that the purchaser consequently has or will have real equity in the activity, and therefore that the financing may appropriately be treated as an amount at risk. Where the lender is a related person with respect to the taxpayer (other than the seller or the promoter, or a person related to either of them), however, Congress was concerned about opportunities for overvaluation of property (resulting in inflated deductions) and for the transfer of tax benefits attributable to amounts that resemble equity. Accordingly, financing from such a related person may be treated as an amount at risk under the Act only if the terms of the loan are commercially reasonable and on substantially the same terms as loans involving unrelated persons.

Explanation of Provision

Under the Act, the at-risk rules (which continue to apply to activities other than holding real property) are extended to the activity of holding real property. In the case of such a real estate activity, the Act provides an exception for qualified nonrecourse financing which is secured by real property used in the activity; the taxpayer is treated at-risk with respect to such financing. In the case of a real estate activity involving nonrecourse financing from related persons (not including the seller, a person receiving a fee for the investment (such as a promoter), or a person related to either of them), the financing can be treated as an amount at risk only if the terms of the loan are commercially reasonable and on substantially the same terms as loans involving unrelated persons.

Qualified nonrecourse financing

The exception provided for qualified nonrecourse financing is similar to the rules for qualified commercial financing under the investment tax credit at-risk rules of prior law, with certain modifications. Qualified nonrecourse financing generally includes financing that is secured by real property used in the activity and that is loaned by a Federal, State or local government or instrumentality thereof or guaranteed by a Federal, State, or local government, or is borrowed by the taxpayer from a qualified person, with respect to the activity of holding real property (other than mineral property). Convertible debt is not treated as qualified nonrecourse financing.

Generally, to the extent an activity was not subject to the at-risk rules (by virtue of section 465(c)(3)(D) of prior law), it will be treated under the Act as the activity of holding real property. The provision of services and the holding of personal property which is merely incidental to the activity of making real property available as living accommodations is treated as part of the activity of holding real property.

For purposes of the provision, nonrecourse financing means financing with respect to which no person is personally liable, except to the extent otherwise provided in regulations. Regulations may set forth the circumstances in which guarantees, indemnities, or personal liability (or the like) of a person other than the taxpayer will not cause the financing to be treated as other than qualified nonrecourse financing.

Qualified persons include any person actively and regularly engaged in the business of lending money. Such persons generally include, for example, a bank, savings and loan association, credit union, or insurance company regulated under Federal, State, or local law, or a pension trust. However, qualified persons do not include (1) any person from which the taxpayer acquired the property (or a person related to such person), or (2) any person who receives a fee (e.g., a promoter) with respect to the taxpayer's investment in the property (or a person related to such person). Thus, for example, no portion of seller financing and promoter financing is qualified nonrecourse financing.

The Act adopts the definition of related person applicable under the prior law investment tax credit at-risk rules, with modifications. Under this rule, related persons generally include family members, fiduciaries, and corporations or partnerships in which a person has at least a 10-percent interest.

In the case of a real estate activity where nonrecourse financing is from a related person (other than seller or promoter financing, which cannot be treated as qualified nonrecourse financing), additional requirements are imposed. Such amounts can be treated as at risk if the terms of the loan are commercially reasonable and on substantially the same terms as loans involving unrelated persons. Congress imposed these additional requirements in the case of related party nonrecourse financing in real estate activities because of concern not only about the opportunity for overvaluation in related party financing, but also about the transfer of tax benefits attributable to amounts that are in the nature of equity contributions (rather than loans) supplied by related persons.

Congress intends that terms of nonrecourse financing are commercially reasonable if the financing is a written unconditional promise to pay on demand or on a specified date or dates a sum or sums certain in money, and the interest rate is a reasonable market rate of interest (taking into account the maturity of the obligation). If the interest rate is below a reasonable market rate, a portion of the principal may in fact represent interest, with the result that the stated principal amount may exceed the fair market value of the financed property (or the amount that actually is debt for tax purposes, if the property is less than 100 percent debt financed). Generally, an interest rate will not be considered commercially reasonable if it is significantly below the market rate on comparable loans by qualified persons who are not related (within the meaning of sec. 465(b)(3)(C)) to the borrowers under the comparable loans. In addition, it is likely that a loan which would be treated as a "below-market loan" within the meaning of section 7872(e) of the Code is not commercially reasonable.

Similarly, if the interest rate exceeds a reasonable market rate, or is contingent on profits or gross receipts, a portion of the principal amount may in fact represent a disguised equity interest (and a portion of the interest in fact is a return on equity) with the result that the stated principal amount may exceed the fair market value of the financed property (or the amount that actually is debt for tax purposes, if the property is not 100 percent debt financed). Thus, generally, an interest rate will not be considered commercially reasonable if it significantly exceeds the market rate on comparable loans by unrelated qualified persons. Nor will an interest rate be considered commercially reasonable if it is contingent. Congress does not intend, however, to limit the use of interest rates that are not fixed rates, provided that interest is calculated with respect to a market interest index such as the prime rate charged by a major commercial bank, LIBOR, the rate on government securities (such as Treasury bills or notes), or the applicable Federal rate (within the meaning of sec. 1274(d)). For example, an interest rate floating at 1 point above the prime rate charged by a major commercial bank will not generally be considered contingent.

The terms of the financing will also not be considered commercially reasonable if, for example, the term of the loan exceeds the useful life of the property, or if the right to foreclosure or collection with respect to the debt is limited (except to the extent provided under applicable State law).

Generally, Congress intended that the financing be debt with arms' length terms, to carry out the purpose of the at-risk rule to limit deductions to the taxpayer's amount at risk. Thus, nonrecourse financing from a person related to the taxpayer must be on substantially the same terms as financing involving unrelated persons.

Congress also intended that no inference is to be drawn from this provision (permitting certain nonrecourse financing to be treated as at risk without regard to whether the lender is a related person) as to the determination of a partner's distributive share of partnership items of a partnership under section 704, or a partner's share of partnership liabilities under section 752.

Under the Act, convertible debt is not treated as qualified nonrecourse financing. Congress has concluded that it is not appropriate to treat investors as at risk with respect to nonrecourse debt that is convertible and that consequently represents a right to an equity interest, because taxpayers are not intended to be treated as at risk for amounts representing others' rights to equity investments.

A special rule for partnerships provides that partnership-level qualified nonrecourse financing may increase a partner's (including a limited partner's) amount at risk, determined in accordance with his share of the liability (within the meaning of sec. 752), provided the financing is qualified nonrecourse financing with respect to that partner as well as with respect to the partnership. For the purpose of determining whether partnership borrowings are treated as qualified nonrecourse financing with respect to the partnership, the partnership is treated as the taxpayer. For the purpose of determining whether a share of partnership borrowings is treated as qualified nonrecourse financing with respect to a partner, the partner is also treated as the borrower. The amount for which partners are treated as at risk under this rule may not exceed the total amount of the qualified nonrecourse financing at the partnership level.

In the case of property taken subject to a nonrecourse debt which constituted qualified nonrecourse financing in the hands of the original borrower, such debt may be considered as qualified nonrecourse financing as to the original borrower's transferee, provided that all the criteria for qualified nonrecourse financing are satisfied for that debt with respect to the transferee. The same rule applies to subsequent transfers of the property taken subject to the debt, and to the admission of new partners to a partnership (or sale or exchange of a partnership interest), so long as the debt constitutes qualified nonrecourse financing with respect to each transferee or new partner.

Aggregation rules

The prior and present law at-risk aggregation rules (sec. 465(c)(3)(B)) generally apply to the activity of holding real property. Under these rules, Congress intended that if a taxpayer actively participates in the management of several partnerships each engaged in the real estate business, the real estate activities of the various partnerships may be aggregated and treated as one activity with respect to that partner for purposes of the at-risk rules. Also it was intended that the regulations relating to the treatment of at-risk amounts in the case of an affiliated group of corporations (Treasury Reg. sec. 1.1502-45) be appropriately modified, in the case of an affiliated group which is engaged principally in the real estate business, to allow aggregation of the real estate activities, where the component members of the group are actively engaged in the management of the real estate business (not including real estate financing other than between members of the affiliated group).

Credit at-risk rules

The Act extends the investment tax credit at-risk rules (sec. 46(c)(8)) to activities involving real estate where a credit is otherwise allowable.[54] In applying the credit at-risk requirement that the financing not exceed 80 percent of the credit base, in the case of property where only a portion of the basis is eligible for a credit, under regulations, only the financing with respect to that portion shall be taken into account.

Effective Date

The extension of the at-risk rules to the activity of holding real property is effective for property placed in service after December 31, 1986, and for losses attributable to an interest in a partnership or S corporation or other pass-through entity that is acquired after December 31, 1986. One specific transition rule is provided.

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[54] For special rules relating to the application of the credit at-risk rules to the low-income housing credit, see Title II, Part E, *supra*.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $24 million in 1987 and $15 million in 1988, and increase fiscal year budget receipts by $30 million in 1989, $23 million in 1990, and $33 million in 1991.

C. Interest Deduction Limitations (Sec. 511 of the Act and secs. 163 (d) and (h) of the Code)[55]

Prior Law

In general

Under prior law (Code sec. 163(d)), in the case of a noncorporate taxpayer, deductions for interest on indebtedness incurred or continued to purchase or carry property held for investment were generally limited to $10,000 per year, plus the taxpayer's net investment income. Under prior and present law, investment interest paid or accrued during the year which exceeds the limitation on investment interest is not permanently disallowed, but is subject to an unlimited carryover and may be deducted in future years (subject to the applicable limitation) (prior-law sec. 163(d)(2)). Under prior law, interest incurred to purchase or carry certain property subject to a net lease generally was treated as investment interest, if certain trade or business deductions were less than 15 percent of the rental income, or if the lessor was guaranteed a specific return or guaranteed against loss of income.

Income and interest of partnerships and S corporations generally retained their entity level character (as either investment or noninvestment interest or income) in the hands of the partners and shareholders. The prior-law treatment of interest incurred to purchase or carry a partnership interest or S corporation stock was not entirely clear.[56]

Investment income and expenses

Investment income.—Investment income under prior law was income from interest, dividends, rents, royalties, short-term capital gains arising from the disposition of investment assets, and any amount of gain treated as ordinary income pursuant to the depreciation recapture provisions (secs. 1245, 1250, and 1254), but only if the income was not derived from the conduct of a trade or business (sec. 163(d)(3)(A)).

Investment expenses.—In determining net investment income, the investment expenses taken into account were trade or business expenses, real and personal property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income, and depletion, to the extent these expenses were directly connected with the production of investment income.

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[55] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 402; H.Rep. 99-426, pp. 296-301; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1421; S.Rep. 99-313, pp. 802-808; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 151-157 (Conference Report).

[56] Proposed Treas. Reg. sec. 1.57-2(b)(2)(i) implied that the interest would not be investment interest where the underlying assets are not investment assets. Compare Rev. Proc. 72-18, 1972-1 C.B. 740, sec. 4.05 (relating to sec. 265 of the Code), and sec. 163(d)(7); see H.R. Rep. No. 97-760, 97th Cong., 2d Sess. at 476-477 (1982).

For purposes of this determination, depreciation with respect to any property was taken into account on a straight-line basis over the useful life of the property, and depletion was taken into account on a cost basis.

Other interest

Under prior law, no limitation was imposed under section 163(d) on the deductibility of interest on indebtedness incurred for other purposes, e.g. to purchase or carry consumption goods. Under prior and present law, interest on indebtedness incurred in connection with the taxpayer's trade or business is also not subject to the limitation on the deductibility of interest expense under section 163.

Reasons for Change

Investment interest

Under prior law, leveraged investment property was subject to an interest limitation, for the purpose of preventing taxpayers from sheltering or reducing tax on other, non-investment income by means of the unrelated interest deduction. Congress concluded that the interest limitation should be strengthened so as to reduce the mismeasurement of income which can result from the deduction of investment interest expense in excess of current investment income, and from deduction of current investment expenses with respect to investment property on which appreciation has not been recognized.

Under prior law, no part of long-term capital gains were included in net investment income. Congress concluded that the continuation of this rule was inappropriate because long-term capital gains are generally taxed at the same effective rate as ordinary income when the Act is fully phased in.

Personal interest

Prior law excluded or mismeasured income arising from the ownership of housing and other consumer durables. Investment in such goods allowed consumers to avoid the tax that would apply if funds were invested in assets producing taxable income and to avoid the cost of renting these items, a cost which would not be deductible in computing tax liability. Thus, the tax system under prior law provided an incentive to invest in consumer durables rather than assets which produce taxable income and, therefore, an incentive to consume rather than save.

Although Congress believed that it would not be advisable to subject to income tax imputed rental income with respect to consumer durables owned by the taxpayer, it nevertheless concluded that it is appropriate and practical to address situations where personal expenditures are financed by borrowing. By phasing out the present deductibility of personal interest, Congress intended to eliminate from the prior tax law a significant disincentive to saving.

While Congress recognized that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, the Congress nevertheless determined that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. Therefore, the personal interest limit does not affect the deductibility of interest on debt secured by the taxpayer's principal residence or second residence, to the extent of the basis of the principal residence (or second residence). In addition, because the Congress intended to provide special treatment to taxpayers who borrow to finance medical or educational expenses, interest on debt secured by the taxpayer's principal residence or second residence that is used to pay educational or medical expenses of the taxpayer or a family member is deductible, even though such borrowings cause the total debt secured by the residence to exceed the taxpayer's basis in the residence, provided the total debt does not exceed the fair market value of the residence.

Explanation of Provisions

In general

In general, under the Act, personal interest is not deductible, and the deduction for investment interest is limited to investment income for the year with an indefinite carryforward of disallowed investment interest. The personal interest limitation does not apply to interest on debt secured by the taxpayer's principal residence (to the extent of its basis plus the amount of such debt used to pay certain educational or medical expenses) and interest on debt secured by a second residence of the taxpayer (to the extent of its basis plus the amount of such debt used to pay certain educational or medical expenses), provided the total amount of such debt does not exceed the fair market value of such residence.

The Act provides that the deduction for investment interest is limited to the amount of net investment income. Interest disallowed under the provision is carried forward and treated as investment interest in the succeeding taxable year. Interest disallowed under the provision is allowed in a subsequent year only to the extent the taxpayer has net investment income in such year. Interest expense that is paid or incurred in carrying on a trade or business is not subject to the interest deduction limitations under the Act but may be subject to the passive loss limitation (Act sec. 501) in some circumstances.

Definition of investment interest

Investment interest is defined to include interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. For this purpose, any interest held by the taxpayer in an activity involving a trade or business which is not a passive activity under the passive loss rule (as added by sec. 501 of the Act) and in which the taxpayer does not materially participate is treated as held for investment. Investment interest also includes interest expense properly allocable to portfolio income under the passive loss rule.

In addition, investment interest includes the portion of interest expense on indebtedness incurred or continued to purchase or carry an interest in a passive activity, to the extent attributable to portfolio income (within the meaning of the passive loss rule).

Investment interest does not include any interest that is taken into account in determining the taxpayer's income or loss from a passive activity.[57] Investment interest does not include interest properly allocable to a rental real estate activity in which the taxpayer actively participates, within the meaning of the passive loss rule. Investment interest also does not include any qualified residence interest, as described below.

Net investment income

Investment income includes gross income from property held for investment, gain (whether long term or short term) attributable to the disposition of property held for investment, and amounts treated as gross portfolio income under the passive loss rule.[58] Investment income also includes income from interests in activities, involving a trade or business, in which the taxpayer does not materially participate, if that activity is not treated as a passive activity under the passive loss rule.

Net investment income is investment income net of investment expenses. Investment expenses are deductible expenses (other than interest) directly connected with the production of investment income. Under the Act, if depreciation or depletion deductions are allowed with respect to assets that produce investment income, investment expense is determined utilizing the actual depreciation or depletion deductions allowable. In determining other deductible investment expenses, it is intended that investment expenses be considered as those allowed after application of the rule limiting deductions for miscellaneous expenses to those expenses exceeding two percent of adjusted gross income. In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.

Property subject to a net lease is not treated as investment property under this provision, to the extent it constitutes a rental activity that is treated as a passive activity under the passive loss rule. Income from a rental real estate activity in which the taxpayer actively participates is not included in investment income.

The investment interest limitation is not intended to disallow a deduction for interest expense which in the same year is required to be capitalized (e.g., construction interest subject to sec. 263A) or is disallowed (e.g., under sec. 265 (relating to tax-exempt interest)).

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[57] As under prior law, interest on indebtedness incurred to purchase an interest in a trade or business partnership as a general partner (that is not treated as an interest in a passive activity) generally is not treated as investment interest for purposes of sec. 163(d). See, e.g., Technical Advice Memorandum 8235004 (May 21, 1982). Similarly, it is intended that interest on indebtedness to acquire stock in an S corporation whose assets are used solely in conducting a trade or business, where the stock is not an interest in a passive activity because the taxpayer materially participates in the trade or business of the S corporation, is not investment interest, but rather is treated as interest incurred or continued in connection with a trade or business. In addition, interest treated as allocable to an interest in a partnership, or stock in an S corporation, that is treated as an interest in a passive activity under the passive loss rule (see discussion of the passive loss rule, *supra*), is not subject to the investment interest limitation (except to the extent such interest expense is allocated to portfolio income under the passive loss rule).

[58] A technical correction (deleting the flush language at the end of Act sec. 163(d)(4)(B)) may be needed so that the statute reflects this intent. Such a correction was included in the versions of H. Con. Res. 395 that passed the House and the Senate in the 99th Congress.

Personal interest

Under the Act, personal interest is not deductible. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee),[59] investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year. Thus, personal interest includes, for example, interest on a loan to purchase an automobile, interest on a loan to purchase a life insurance policy, and credit card interest, where such interest is not incurred or continued in connection with the conduct of a trade or business. Personal interest also includes interest on underpayments of individual Federal, State or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from the conduct of a trade or business.[60] However, personal interest does not include interest payable on estate tax deferred under sections 6163 or 6166.

Personal interest does not include qualified residence interest of the taxpayer, as discussed below.

Qualified residence interest

Under the Act, qualified residence interest is not subject to the limitation on personal interest. Qualified residence interest generally means interest on debt secured by a security interest valid against a subsequent purchaser under local law on the taxpayer's principal residence or a second residence of the taxpayer.[61] Qualified residence interest means interest on such debt to the extent that the debt does not exceed the amount of the taxpayer's basis for the residence (including the cost of home improvements), plus the amount of qualified medical and qualified educational expenses. Qualified residence interest does not include interest on any portion of such debt in excess of the fair market value of the residence. Interest on a loan secured by a recorded deed of trust, mortgage, or other security interest in a taxpayer's principal or second residence, in a State such as Texas where such recorded security instrument will be rendered ineffective or the enforceability of such instrument will be otherwise restricted by State and local laws such as the Texas homestead law, shall be treated as qualified residence interest, provided that such interest is otherwise qualified residence interest.[62] The fact that, under applicable State or local law, a buyer does not acquire legal title to a residence he has purchased by means of debt until the debt is fully paid is not intended to have the result that the debt is treated as not secured by the residence, for purposes of this provision. Qualified residence interest is not subject to the limitation on personal interest even though the borrowed funds are used for personal expenditures.

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[59] Thus, for example, interest on debt to finance an employee business expense is not deductible, under this rule.

[60] Personal interest does not include interest on taxes, other than income taxes, that are incurred in connection with a trade or business. (For the rule that taxes on net income are not attributable to a trade or business, see Treas. Reg. sec. 1.62-1(d), relating to nondeductibility of State income taxes in computing adjusted gross income.) In addition, personal interest does not include interest of an S corporation which is attributable to an underpayment of income tax from a year in which the corporation was a C corporation or from the underpayment of the taxes imposed by sec. 1374 or 1375. Nor does personal interest include interest on an underpayment of income tax of a corporation payable by a shareholder by reason of transferee liability (under sec. 6901).

[61] Generally, under local law such a security interest must be recorded.

[62] See colloquy between Senators Bentsen and Packwood, 132 Cong. Rec. S13956 (September 27, 1986); and Statement of Chairman Rostenkowski, 132 Cong. Rec. H8363 (September 25, 1986).

Residences of the taxpayer.—The taxpayer's principal residence is intended to be the residence that would qualify for rollover of gain under section 1034 if it were sold. A principal residence may be a condominium or cooperative unit.[63] A dwelling unit will qualify as a residence only if it meets the requirements for use as a residence under section 280A. A second residence of the taxpayer includes a dwelling unit used by the taxpayer as a residence within the meaning of section 280A (gain on which could qualify for rollover treatment under section 1034 if the residence were used as a principal residence). If a second residence is not rented at any time during the taxable year, the taxpayer need not meet the requirement of section 280A(d)(1) that the residence be used for personal (nonrental) purposes for the greater of 14 days or 10 percent of the number of days it is rented.[64] In the case of a joint return, a second residence includes a residence used by the taxpayer or his spouse and which is owned by either or both spouses.

Qualified residence interest may include interest paid by the taxpayer on debt secured by a residence of the taxpayer that he owns jointly or as a tenant in common, provided that all the requirements for qualified residence interest are met.

Qualified residence interest not treated as personal interest under the provision may include all or a portion of the interest on debt secured by the taxpayer's stock in a housing cooperative unit that is a residence of the taxpayer, or by his proprietary lease with respect to the unit. In addition, qualified residence interest not treated as personal interest under the provision may include all or a portion of the taxpayer's share under section 216 of interest expense of the housing cooperative allocable to his unit and to his share of common residential (but not commercial) areas of the cooperative. In applying the qualified residence interest exception where the taxpayer's residence is a cooperative housing unit, it is intended that regulations will be issued providing that the basis and fair market value limitations will apply in such a way as to achieve a result comparable to that which would occur if the taxpayer owned his share of the assets of the cooperative directly.

In the case of housing cooperatives, debt secured by stock held by the taxpayer as a tenant-stockholder is treated as secured by the residence the taxpayer is entitled to occupy as a tenant-stockholder. Where the stock may not be used as security by virtue of restrictions arising, for example, pursuant to local or State law, or pursuant to reasonable restrictions in the cooperative agreement, the stock may be treated as securing such debt, if the taxpayer establishes to the satisfaction of the Internal Revenue Service that the debt was incurred to acquire the stock.

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[63] A principal residence may also include a houseboat or house trailer. See Treas. Reg. sec. 1.1034-1(c)(3).

[64] A technical correction may be needed so that the statute properly reflects this intent. Such a correction was included in the versions of H. Con. Res. 395 that passed the House and the Senate in the 99th Congress.

In the case of a husband and wife filing separate returns, each spouse may deduct interest on debt secured by one residence. Alternatively the spouses may consent in writing to allow one spouse to claim interest on debt secured by two residences at least one of which is a principal residence. In the latter case, any interest of the other spouse on debt secured by a residence is treated as interest which may be subject to disallowance.

In the case of a taxpayer who owns more than two residences, the taxpayer may designate each year which residence (other than the taxpayer's principal residence) the taxpayer wishes to have treated as the second residence.

Amount of limitation.—Qualified residence interest is calculated as interest on debt secured by the residence, up to the amount of the basis of the residence, plus the amount incurred after August 16, 1986, for qualified medical and educational expenses. If the amount of any debt incurred on or before August 16, 1986, and secured by the residence on August 16, 1986 (reduced by any principal payments thereon) exceeds the taxpayer's basis for the residence, then such amount (reduced by any principal payments thereon) shall be substituted for the taxpayer's basis in applying the preceding sentence. Increases after August 16, 1986 in the amount of debt secured by the residence on August 16, 1986 (for example, in the case of a line of credit) are treated as incurred after August 16, 1986. Thus, interest on outstanding debt secured by the taxpayer's principal or second residence, incurred on or before August 16, 1986, is treated as fully deductible (to the extent the debt does not exceed the fair market value of the residence), regardless of whether the borrowed funds are used for personal expenditures. Interest on debt secured by the taxpayer's principal or second residence, incurred after August 16, 1986, which debt exceeds the taxpayer's basis in the residence, is allowed only if the debt is incurred for qualified medical or educational expenses.

For purposes of determining qualified residence interest, the amount of the taxpayer's basis is determined without taking into account adjustments to basis under section 1034(e) (relating to rollover of gain upon the sale of the taxpayer's principal residence), or 1033(b) (relating to involuntary conversions). The basis for the residence includes the cost of improvements to the residence that are added to the basis of the residence.[65] The taxpayer's basis is determined without regard to other adjustments to basis, such as depreciation. Thus, for example, if a taxpayer's second residence is rented to tenants for a portion of the year, and its basis is reduced by deductions for depreciation allowed in connection with the rental use of the property, the amount of his basis for the residence is not reduced by such deductions for purposes of this provision. Where the basis of a residence is determined under section 1014 (relating to the basis of property acquired from a decedent), the basis under this provision is the basis determined under section 1014 (plus the cost of home improvements made by the taxpayer that are included in basis). In general, under this provision, the amount of debt on which the taxpayer may deduct interest as qualified interest will not be less than his purchase price for the residence.

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[65] In the case of a home improvement loan, it is intended that the basis limitation under this provision will be adjusted to reflect the use of the loan proceeds for home improvements.

Generally, interest on debt secured by the taxpayer's principal or second residence (up to the amount of the taxpayer's basis) is treated as qualified residence interest. Thus, for example, if the taxpayer's basis in his principal residence is $100,000 (and this amount does not exceed fair market value), and the residence is secured by debt in the amount of $60,000, interest on a refinancing for a total of $100,000 (including the original $60,000 plus an additional $40,000) is treated as qualified residence interest, regardless of the fact that the borrowed funds are used for personal expenditures by the taxpayer.

Qualified medical expenses are those amounts paid for medical care within the meaning of sec. 213(d)(1)(A) and (B) (not including amounts paid for insurance covering medical care under sec. 213(d)(1)(C)), of the taxpayer, his spouse and dependents.

Qualified educational expenses are those amounts paid for reasonable living expenses while away from home, and for any tuition and related expenses incurred that would qualify as scholarships (under sec. 117(b) as amended by the Act), for the taxpayer, his spouse or dependent, while a student at an educational organization described in section 170(b)(1). Thus, tuition expenses for primary, secondary, college and graduate level education are generally included in qualified educational expenses. The qualified educational expenses or qualified medical expenses must be incurred within a reasonable period of time before or after the debt is incurred. Medical or educational expenses that are reimbursed are not intended to be treated as qualified medical or educational expenses.

Interest on debt that is used to pay qualified medical or educational expenses, to be deductible as qualified residence interest, must be secured by the taxpayer's principal residence or second residence. Interest expense is so treated if the debt is so secured at the time the interest is paid or accrued.

Effective Date

The investment and personal interest limitations, as amended by the Act, are effective for taxable years beginning on or after January 1, 1987, regardless of when the obligation was incurred. The limitations are phased in. The personal interest limitation and the investment interest limitation are each phased in separately at the same rate.

Investment interest.—Under the Act, the amount of investment interest disallowed during the phase-in period is generally the sum of (i) the amount of investment interest that would have been disallowed under prior law plus (ii) the applicable portion of the additional amount of investment interest that would be disallowed once the provision is fully phased in. The amount of passive losses allowed under the passive loss phase-in rule (supra) that are subtracted from investment income are subject the investment interest phase-in applicable percentages.[66]

The applicable percentage under the investment interest phase-in rule is 35 percent in 1987, 60 percent in 1988, 80 percent in 1989, 90 percent in 1990 and 100 percent in 1991 and thereafter. Thus, for example, if an individual taxpayer has $20,000 of investment interest expense in excess of investment income in 1987, 35 percent of the amount that does not exceed $10,000 or $3,500, plus the amount in excess of the $10,000 allowance would be disallowed. Thus, $13,500 would be disallowed, and $6,500 would be allowed for 1987 (assuming the taxpayer had no net passive loss for the year).

With respect to the investment interest limitation, for taxable years beginning on or after January 1, 1987 and before January 1, 1991, the amount of net investment income is reduced by the amount of losses from passive activities that is allowed as a deduction by virtue of the phase-in of the passive loss rule (other than net losses from rental real estate in which the taxpayer actively participates). For example, if a taxpayer has a passive loss which would be disallowed were the passive loss rule fully phased in (as in taxable years beginning after December 31, 1990), but a percentage of which is allowed under the passive loss phase-in rule, the amount of loss so allowed reduces the amount of the taxpayer's net investment income under the investment interest limitation for that year.

Further, any amount of investment interest that is disallowed under the investment interest limitation during the period that the investment interest limitation is phased in (that is, taxable years beginning on or after January 1, 1987 and before January 1, 1991) is not allowed as a deduction in a subsequent year except to the extent the taxpayer has net investment income in excess of investment interest in the subsequent year.[67]

Personal interest.—The limitation on personal interest is phased in over the same period and applying the same percentages as for the investment interest limitation. No carryforwards are permitted for disallowed personal interest.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $620 million in 1987, $4,511 million in 1988, $6,260 million in 1989, $8,370 million in 1990, and $9,597 million in 1991.

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[66] A technical correction may be needed so that the statute properly reflects this intent. Such a correction was included in the versions of H. Con. Res. 395 that passed the House and the Senate.

[67] For example, assume that, in 1987, the taxpayer has a passive loss of $80,000 of which $30,000 is attributable to rental real estate activities in which the taxpayer actively participates. Assuming the taxpayer is entitled to deduct $25,000 of active rental losses, then 35 percent of the remaining $55,000, or $19,250, would be suspended under the passive loss limitation. Of the deductible $35,750 of passive losses, the portion not attributable to active rental activities reduces the taxpayer's net investment income under the investment interest limitation for 1987.

That portion is determined by first calculating the ratio of (1) the amount of 1987 losses that are *not* attributable to rental real estate activities in which the taxpayer actively participates ($50,000) to (2) the amount of 1987 losses that are subject to the passive loss phase-in rule ($55,000). The ratio is applied to the total amount of passive losses allowed in 1987, other than those allowed under the $25,000 allowance ($35,750), to determine the portion allowed under the passive loss phase-in rule. This portion (i.e., $32,500) is subtracted from the amount of net investment income, under the investment interest limitation phase-in rule.

TITLE VI—CORPORATE TAXATION

A. Corporate Tax Rates (Sec. 601 of the Act and sec. 11 of the Code)[1]

Prior Law

Under prior law, corporate taxable income was subject to tax under a 5-step graduated rate structure. The top corporate tax rate was 46 percent on taxable income over $100,000. The corporate taxable income brackets and tax rates were as set forth in the table below.

Taxable income	Tax rate (percent)
Not over $25,000	15
Over $25,000 but not over $50,000	18
Over $50,000 but not over $75,000	39
Over $75,000 but not over $100,000	40
Over $100,000	46

This schedule of corporate tax rates was originally enacted in the Economic Recovery Tax Act of 1981 (ERTA), effective for 1983 and later years. For 1982, the applicable rates were 16 percent for taxable income not over $25,000, and 19 percent for taxable income over $25,000 but not over $50,000. For taxable years after 1978 and before 1982, the rates were 17 percent and 20 percent, respectively, for the lowest two brackets.

An additional 5-percent corporate tax was imposed on a corporation's taxable income in excess of $1 million. The maximum additional tax was $20,250. This provision phased out the benefit of graduated rates for corporations with taxable income between $1,000,000 and $1,405,000; corporations with taxable income in excess of $1,405,000, in effect, paid a flat tax at a 46-percent rate. This provision was enacted in the Deficit Reduction Act of 1984, effective for taxable years beginning after 1983.[2]

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 301; H.Rep. 99-426, pp. 231-233; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 601; S.Rep. 99-313, pp. 219-221; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 158-159 (Conference Report).

[2] Under prior and present law, rules are provided in the Code to prevent the benefits of graduated rates from being proliferated through the use of multiple, commonly controlled corporations (secs. 1551, 1561-1564). Other statutory provisions attempt to limit the use of corporations to avoid the imposition of individual income tax. These are principally the accumulated earnings tax (sec. 531 et seq.), the personal holding company tax (sec. 541 et seq.), and certain personal service corporation provisions (sec. 269A).

Reasons for Change

A principal objective of the Act was to reduce marginal tax rates on income earned by individuals and by corporations. Congress believed that lower tax rates promote economic growth by increasing the rate of return on investment. Lower tax rates also improve the allocation of resources within the economy by reducing the impact of tax considerations on business and investment decisions. In addition, lower tax rates promote compliance by reducing the potential gain from engaging in transactions designed to avoid or evade income tax. Under the Act, the maximum corporate rate is reduced from 46 percent to 34 percent.

Although Congress believed that the graduated rate structure should be retained to encourage growth in small business, it felt that the benefit of the lower rates should be limited to smaller corporations. Accordingly, under the Act the benefit of the graduated rate structure is phased out beginning at $100,000 of taxable income as compared to $1 million under prior law. In addition, Congress simplified the graduated rate structure for corporations by reducing the number of brackets from five to three.

Explanation of Provision

Under the Act, tax would be imposed on corporations under the schedule shown in the following table.

Taxable income	Tax rate (percent)
Not over $50,000	15
$50,000 to $75,000	25
Over $75,000	34

An additional 5-percent tax is imposed on a corporation's taxable income in excess of $100,000. The maximum additional tax is $11,750. This provision phases out the benefit of graduated rates for corporations with taxable income between $100,000 and $335,000; corporations with income in excess of $335,000, in effect, will pay a flat tax at a 34-percent rate.

Effective Date

The revised corporate tax rates are effective for taxable years beginning on or after July 1, 1987. Income in taxable years that include July 1, 1987 (other than as the first date of such year) is subject to a blended rate under the rules specified in section 15 of the Code.

Under section 15, tentative taxes for the entire taxable year are first computed by 1) applying the rates (including the applicable phaseout of the graduated rates) for the period before July 1, 1987 to the taxable income for the entire taxable year, and 2) applying the rates (including the applicable phaseout of the graduated rates) for the period on and after July 1, 1987 to the entire taxable year. The actual tax for the taxable year is then computed as the sum of that proportion of each tentative tax which the number of days in each period bears to the number of days in the entire taxable year.[3]

As one example, in the case of a calendar year corporate taxpayer with $2 million of ordinary taxable income, the tax for 1987 is computed by first determining a tentative tax under prior law of $920,000 (46 percent of $2 million) and a tentative tax under the amended law of $680,000 (34 percent of $2 million). The actual tax equals the sum of $456,219.18 (181/365 of $920,000) and $342,794.52 (184/365 of $680,000) or $799,013.70.[4]

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $6,711 million in 1987, $20,068 million in 1988, $27,505 million in 1989, $29,999 million in 1990, and $32,415 million in 1991.

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[3] *See* Treas. Reg. sec. 1.21-1(b).

[4] 181 is the number of days in the calendar year 1987 prior to July 1; 184 is the number of days in the calendar year 1987 on or after July 1.

B. Corporate Dividends Received Deduction (Sec. 611 of the Act and secs. 243-246A of the Code)[5]

Prior Law

Under prior law, corporations that received dividends generally were entitled to a deduction equal to 85 percent of the dividends received (sec. 243(a)(1)). Under prior and present law, dividends received from a small business investment company operating under the Small Business Investment Act of 1958 (sec. 243(a)(2)), and "qualifying dividends" received from certain members of an affiliated group, are eligible for a 100-percent dividends received deduction (sec. 243(a)(3)). In addition, under prior and present law, pursuant to Treasury regulations, dividends received by one member of an affiliated group filing a consolidated return from another member of the group are not taxed to the recipient (Treas. Reg. sec. 1.1502-14).

There are exceptions for certain dividends received by a U.S. corporation from a foreign corporation and from certain other entities. The dividends received deduction is limited in certain other circumstances.

Reasons for Change

Under prior law, dividends eligible for the 85-percent dividends received deduction were taxed at a maximum rate of 6.9 percent (15 percent of the top corporate rate of 46 percent). The Congress did not believe that the reduction in corporate tax rates generally should result in a significant reduction in this effective rate. Thus, the dividends received deduction has been reduced to 80 percent, resulting in a maximum rate of 6.8 percent on dividends subject to the reduced top corporate rate (20 percent of the top corporate rate of 34 percent).

Explanation of Provision

Under the Act, the 85-percent dividends received deduction is lowered to 80 percent.

Effective Date

The reduction in the dividends received deduction is applicable to dividends received or accrued after December 31, 1986, in taxable years ending after such date.

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[5] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 303; H.Rep. 99-426, pp. 243-246; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 611; S.Rep. 99-313, pp. 221; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 161 (Conference Report).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $140 million in 1987, $223 million in 1988, $225 million in 1989, $239 million in 1990, and $253 million in 1991.

C. Dividend Exclusion for Individuals (Sec. 612 of the Act and sec. 116 of the Code)[6]

Prior Law

Under prior law, the first $100 of qualified dividends received by an individual shareholder ($200 by a married couple filing jointly) from domestic corporations was excluded from income (sec. 116(a)).

The dividend exclusion for individuals did not apply to dividends received from an organization that was exempt from tax under section 501 or a tax-exempt farmers' cooperative in either the year of distribution or the preceding year (sec. 166(b)(1)), dividends received from a real estate investment trust (sec. 116(b)(2)), dividends received from a mutual savings bank that received a deduction for the dividend under section 591 (sec. 116(c)(1)), or to an ESOP dividend for which the corporation received a deduction (sec. 116(e)). The exclusion was limited with respect to dividends received from a regulated investment company (sec. 116(c)(2)).

Reasons for Change

The Congress believed that the dividend exclusion for individuals under prior law provided little relief from the two-tier corporate income tax because of the low limitation. As an exclusion from income, it also tended to benefit high-bracket taxpayers more than low-bracket taxpayers. On balance, the Congress believed it is preferable to eliminate the exclusion and use the revenues to reduce tax rates.

Explanation of Provision

Under the Act, the dividend exclusion for individuals is repealed.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by $212 million in 1987, $573 million in 1988, $580 million in 1989, $605 million in 1990, and $631 million in 1991.

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[6] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 313; H.Rep. 99-426, p. 247; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 612; S.Rep. 99-313, p. 222; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 162 (Conference Report).

D. Stock Redemption Payments (Sec. 613 of the Act and section 162(l) of the Code)[7]

Prior Law

Under prior and present law, a deduction is allowed for all ordinary and necessary business expenses incurred during the taxable year in carrying on a trade or business (sec. 162(a)). A deduction is not allowed currently, however, for the costs of acquiring property whose life extends substantially beyond the close of the taxable year; such costs must be capitalized (sec. 263).

The purchase of stock, including the repurchase by an issuing corporation of its own stock, is generally treated as a capital transaction that does not give rise to a current deduction. Some authority existed under prior law for the proposition that, in certain extraordinary circumstances, amounts paid by a corporation to repurchase its stock may be fully deductible in the year paid. The validity of this authority, however, has been questioned. Thus, in *Five Star Manufacturing Co.* v. *Comm'r*, 355 F.2d 724 (5th Cir. 1966), the court relied on the fact that liquidation of the corporation was imminent in the absence of the repurchase, and that no value would have been realized by the shareholders on such a liquidation, in upholding the deduction of the payments. Subsequent cases, however, strictly limited the holding in *Five Star* to its peculiar facts,[8] or questioned its validity.[9]

The Supreme Court has held that the requirement that stock redemption payments be capitalized extends not only to amounts representing consideration for the stock itself, but also to expenses such as legal, brokerage, and accounting fees incident to the acquisition.[10]

Reasons for Change

Congress understood that some corporate taxpayers were taking the position that expenditures incurred to repurchase stock from stockholders to prevent a hostile takeover of the corporation by such shareholders—so-called "greenmail" payments—were deductible business expenses. Congress wished to provide expressly that all expenditures by a corporation incurred in purchasing its own stock, whether representing direct consideration for the stock, a premium payment above the apparent stock value, or costs incident to the purchase, and whether incurred in a hostile takeover situation or otherwise, are nonamortizable capital expenditures.

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[7] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 314; H.Rep. 99-426, pp. 248-249; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 613; S.Rep. 99-313, pp. 222-224; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 168-169 (Conference Report).

[8] See, e.g., *Jim Walter Corp.* v. *United States*, 498 F. 2d 631 (5th Cir. 1974); *Markham & Brown, Inc.* v. *United States*, 648 F.2d 1043 (5th Cir. 1981); *H. & G. Industries* v. *Comm'r*. 495 F.2d 653 (3d Cir. 1974); *Harder Services, Inc.* v. *Comm'r*. 67 T.C. 585 (1976), aff'd without opinion 573 F.2d 1290 (2d Cir. 1977).

[9] See, e.g., *Proskauer v. Comm'r*. 46 T.C.M. 679, 684 (1983), noting that the *Five Star* court may have applied the "primary purpose" standard that was often used in determining whether the expenditure was capital in nature before the Supreme Court's rejection of that standard in *Woodward* v. *Comm'r*. 397 U.S. 572 (1970).

[10] See *Woodward* v. *Comm'r*, supra; *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970).

Explanation of Provision

The Act denies a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock. Congress intended that amounts subject to this provision will include amounts paid to repurchase stock; premiums paid for the stock; legal, accounting, brokerage, transfer agent, appraisal, and similar fees incurred in connection with the repurchase; and any other expenditure that is necessary or incident to the repurchase, whether representing costs incurred by the purchasing corporation or by the selling shareholder (and paid or reimbursed by the purchasing corporation), or incurred by persons or entities related to either.[11] The provision was also intended to apply to any amount paid by a corporation to a selling shareholder (or any related person) pursuant to an agreement entered into as part of or in connection with a repurchase of stock, whereunder the seller agrees not to purchase, finance a purchase, acquire, or in any way be a party or agent to the acquisition of stock of the corporation for a specified or indefinite period of time (so-called "standstill" agreements).

The provision does not apply to interest deductible under section 163. In addition, it does not apply to amounts constituting dividends within the meaning of section 561, relating to payments (or deemed payments) for purposes of the accumulated earnings, personal holding company, and foreign personal holding company taxes, and for purposes of the regular income tax in the case of regulated investment companies and real estate investment trusts.[12] Thus, such amounts continue to qualify for the dividends paid deduction to the same extent as under prior law.

Further, the provision does not apply to otherwise deductible expenses incurred by a regulated investment company that is an open-end mutual fund in connection with the redemption of its stock upon the demand of a shareholder. Thus, for example, costs incurred by such a company in processing applications for redemption and issuing checks in payment for redeemed shares are deductible to the same extent as under prior law.[13]

While the phrase "in connection with [a] redemption" was intended to be construed broadly, Congress did not intend the provision to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time or arising out of the same general circumstances. For example, if a corporation redeems a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision.[14] Payments in discharge of other types of contractual obligations, in settlement of litigation, or pursuant to other actual or potential legal obligations or rights, may also be outside the intended scope of the provision to the extent it is clearly established that the payment does not represent consideration for the stock or expenses related to its acquisition, and is not a payment that is a fundamental part of a "standstill" or similar agreement.

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[11] Thus, the provision was intended to apply where the costs are incurred indirectly as well as directly, for example, by a controlling shareholder, a controlled subsidiary, or other related party.

[12] See secs. 535, 545, 556, 852, and 857.

[13] See Rev. Rul. 73-463, 1973-2 C.B. 34.

Congress anticipated that where a transaction is not directly related to a redemption but is proximate in time, the Internal Revenue Service will scrutinize the transaction to determine whether the amount purportedly paid in the transaction is reasonable. Thus, even where the parties have countervailing tax interests, the parties' stated allocation of the total consideration between the redemption and the unrelated transaction will be respected only if it is supported by all the facts and circumstances.[15]

However, Congress intended that agreements to refrain from purchasing stock of a corporation or other similar types of "standstill" agreements in all events will be considered related to any redemption of the payee's stock. Accordingly, payments pursuant to such agreements are nondeductible under this provision provided there is an actual purchase of all or part of the payee's stock. Congress intended no inference regarding the deductibility of payments under standstill or similar agreements that are unrelated to any redemption of stock owned by the payee.

In denying a deduction for payments in connection with redemptions of stock, Congress intended no inference regarding the deductibility of such payments under prior law. Moreover, no inference was intended as to the character of such payments in the hands of the payee.

Effective Date

The provision is effective for amounts paid or incurred after February 28, 1986.

Revenue Effect

The provision is estimated to have no effect on fiscal year budget receipts.

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[14] This would be so whether the employment contract and the redemption agreement were contained in one document or separate documents, and whether or not they were separately negotiated. Likewise, this provision was not intended to deny an employer a deduction for compensation where a deduction has been deferred under other provisions of the Code, and the deduction becomes allowable when the employer reacquires the employee's stock. See, e.g., sections 83 and 421(b).

[15] *Compare American International Coal Co. v. Comm'r*, PH Memo TC para. 82,204 (1982) (corporation's payment to shareholder-employee was nondeductible distribution in redemption of stock, not compensation for services) *with Atwater & Co. v. Comm'r*, 10 T.C. 218 (1948) (corporation's payment to shareholder-employee under agreement to repurchase shares upon termination of employment, *held*, deductible to extent represented additional compensation for services).

E. Extraordinary Dividends Received by Corporate Shareholders (Sec. 614 of the Act and sec. 1059 of the Code)[16]

Prior Law

Under prior (and present) law, if a corporate shareholder received an "extraordinary dividend" on stock and disposed of the stock without having held it for more than one year, the basis of the stock was reduced by the amount of the nontaxed portion of the dividend (sec. 1059). If the nontaxed portion of an extraordinary dividend exceeded the shareholder's adjusted basis in the stock with respect to which it was paid, the excess was treated as gain from the sale or exchange of property at the date on which the stock became ex-dividend.

An extraordinary dividend was defined in terms of the size of the dividend in relation to the shareholder's adjusted basis of the share of stock with respect to which it was distributed. A dividend was extraordinary if it equalled or exceeded a "threshold percentage" of 10 percent (5 percent in the case of a share of stock preferred as to dividends) of the shareholder's basis in the share, determined without regard to this provision.

In the case of a cash distribution, the nontaxed portion of the dividend was the amount offset by the dividends received deduction. In the case of a distribution of property, the nontaxed portion was the fair market value of the property (reduced, as provided in section 301(b)(2), for liabilities assumed by the shareholder or to which the shareholder is subject), less any portion of such amount that is not offset by the dividends received deduction.

In general, under both prior and present law, a distribution in redemption of stock that is essentially equivalent to a dividend is treated as a dividend for tax purposes (sec. 302). A redemption of the stock of a shareholder is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. In some situations it is unclear what constitutes a meaningful reduction in interest. Distributions in partial liquidation of the distributing corporation are not treated as dividends if the recipient is a non-corporate shareholder.

Reasons for Change

Congress believed that the extraordinary dividend provision, as enacted in 1984, had not been an adequate deterrent to the tax-motivated transactions at which the provision was directed. Taxpayers were able to obtain the tax benefits that Congress intended to curtail, simply by holding stock beyond the one-year period.

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[16] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 614; S. Rep. 99-313, pp. 248-250; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 163-166 (Conference Report).

For example, under prior law, a corporation could acquire stock in another corporation following or in anticipation of the latter's announcement that it would pay a large dividend and could hold the stock with the intention of disposing of it shortly after the expiration of the one-year holding period necessary to avoid a basis reduction under section 1059. After the distribution, the shareholder would have dividend income taxable under prior law at a maximum rate of 6.9 percent, and the market price of the dividend-paying stock would have declined by approximately the value of the dividend. However, provided the stock was held for more than one year, the shareholder's basis in the shares would reflect its full cost, since no reduction in the basis was required. The taxpayer could then dispose of the stock for an amount reflecting the decrease in market price due to payment of the dividend. Since the taxpayer's basis in the stock was not reduced, this disposition could either create a long-term capital loss for tax purposes (which the taxpayer could use to offset other capital gains), or it might reduce any long-term capital gain the taxpayer would otherwise have realized on disposition of the stock. Under the prior law maximum 28 percent long-term capital gains rate, the taxpayer could thus receive a tax benefit of 28 percent of the amount of the dividend. Since the dividend was taxed at a maximum rate of 6.9 percent, the taxpayer could thus obtain a 21.1 percent tax "arbitrage" benefit at essentially no actual economic cost.[17] The Act's reduction of the maximum rate on intercorporate dividends to 6.8 percent and the elimination of a preferential rate for long-term capital gains (thus making long-term capital losses relatively more valuable) increases the potential arbitrage benefit for a corporation.

Congress believed that the circumstances should be expanded in which a corporate shareholder is required to reduce its basis in stock for the nontaxed portion of an extraordinary dividend. However, in light of the longer holding period, Congress believed it appropriate to mitigate the application of the definition of extraordinary dividends by reference to basis under prior law, if the shareholder can establish a higher fair market value of the stock to the satisfaction of the Commissioner.

Congress understood that because the law is not entirely clear when a redemption is essentially equivalent to a dividend, there are cases in which individual distributees take the position that a redemption is a sale or exchange, while corporate distributees take the position the redemption is a dividend. Similar differences might occur in the case of partial liquidation distributions that individual distributees must treat as a sale or exchange, if corporate distributees take the position the distribution is a dividend.

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[17] Although the shareholder in such transactions was exposed to the risk that the value of the stock would decline during the one-year holding period, taxpayers continued to engage in such transactions. Given the substantial potential tax benefit, the apparent premise for the more than one year holding period requirement of prior law—that the shareholder's exposure to market risk during this period would be sufficient to deter such tax arbitrage—in many situations appeared to be unfounded.

Explanation of Provisions

Under the Act, a corporation that disposes of a share of stock must reduce its basis in the stock (but not below zero) by the nontaxed portion of any extraordinary dividend paid with respect to the share, if a holding period requirement described below, is not met. Except for purposes of determining whether subsequent distributions are extraordinary, this basis reduction is required only for purposes of determining gain or loss on the disposition of the share. If the aggregate nontaxed portions of extraordinary dividends exceed the shareholder's basis, the excess is treated as gain from a sale or exchange at the time of disposition.

The determination whether a dividend is extraordinary is generally made under the prior law percentage-of-adjusted-basis test. Thus, under the Act, a dividend is extraordinary if it equals or exceeds the "threshold percentage" of 10 percent (5 percent in the case of preferred stock) of the shareholder's basis in the share. However, unlike prior law, for purposes of this determination basis is reduced by the nontaxed portion of any prior extraordinary dividends under the provision. Also, the Act provides a taxpayer the option of determining the status of a distribution as an extraordinary dividend by reference to the fair market value of the share on the day before the ex-dividend date, in lieu of the adjusted basis of the share. This special rule applies only if the taxpayer establishes the fair market value of the share to the satisfaction of the Commissioner.

Instead of the one-year post-acquisition holding period requirement of prior law, the Act provides a test based on the holding period of the distributee as of the date the distribution is declared, announced, or agreed to by the distributing corporation, whichever is earliest. Under this test, an extraordinary dividend distribution with respect to stock will require a basis reduction if the taxpayer has not held the stock for more than two years on the earliest of the date of declaration, announcement, or agreement.

For purposes of determining whether the two-year holding period requirement has been met, a distribution is announced if the amount thereof has been announced, even though legal declaration of the dividend may not have occurred, and even though the distribution may be scheduled to occur at some time in the future, or its payment may otherwise be deferred. Similarly, if there is a formal or informal agreement to pay the particular dividend prior to the declaration date, the date of such agreement shall be treated as the dividend announcement date. Whether there is such a formal or informal agreement is determined based on all the facts and circumstances. In general, a broad agreement in a joint venture arrangement that dividends will be paid as funds are available will not be considered an agreement to pay a particular dividend in the absence of other facts, such as facts showing a particular expectation that a large dividend would be paid after the acquisition of a new interest in the venture.

Although any fixed dividend on preferred stock is in a sense "announced" by the terms of the stock at the time the stock is acquired, it is not intended that all such fixed dividends on the stock, however long it is held, would thus be considered to be "announced or agreed to" within the 2-year period. However, it is intended that the fixed dividends attributable to the first 2 years the preferred stock is held will be considered "announced or agreed to" within the first 2 years, even though a payment date might be missed or there might otherwise be a delay in paying such dividends beyond the first 2 years to which they are attributable. As one example, if newly issued preferred stock provides an annual fixed dividend of 12 percent of its issue price but with the dividends for the first two years to be payable only in the third year after issuance, the dividends attributable to the first two years will be considered "announced or agreed to" within the first two years, and will require basis reduction even if paid to an original holder in the third year after issuance, unless the special relief rule for qualified preferred dividends (described below) applies.

Similarly, if preferred stock provides for a cumulative dividend of 12 percent of annual profits, the dividends attributable to the first 2 years' profits will be subject to the extraordinary dividend tests, and will require basis reduction if the threshold percentage is exceeded, even if the dividends are not paid until the third year. Since such dividends would not be "fixed", in amount, special relief would not be available under the qualified preferred dividend rule described below.

The basis reduction rules are also intended to apply in other situations that attempt to avoid the threshold amount or holding period requirements by deferring or staggering dividend payments.

The Act provides a special rule for certain qualified preferred dividends. Absent this special rule, the basic definition of extraordinary dividend would create an extraordinary dividend if a preferred stock pays, within any period of 85 days or less, dividends equal to or exceeding 5 percent of the shareholder's adjusted basis (or, if applicable, the fair market value of the stock). Thus, for example, under the basic definition, a fixed 6-percent preferred stock dividend that is paid once annually will be extraordinary. On the other hand, under the same basic definition, if the preferred stock paid four quarterly 4.9-percent dividends, none of the dividends will be considered extraordinary.

The special rule for qualified preferred dividends is intended to provide relief for certain transactions to the extent that there is no potential for effectively purchasing a dividend that accrued prior to the date of purchase ("dividend-stripping"). Under the special rule, those dividends that qualify for relief are treated as extraordinary dividends only to the lesser of the extent required by the basic rule or the extent that the aggregate eligible dividends received by the taxpayer during the period it owns the stock exceed the dividends it "earned." Furthermore, if the taxpayer holds the stock for more than 5 years, no basis reduction is required for such dividends.

Preferred stock dividends qualify for relief only if (1) they are fixed (i.e., not varying in amount) preferred dividends, payable not less often than annually; and (2) dividends were not in arrears when the taxpayer acquired the stock. Also, no relief is available if the aggregate dividends received by the taxpayer during the period it owns the stock exceed an annualized rate of 15 percent of the lower of (a) the taxpayer's adjusted basis or (b) the liquidation preference of the stock.[18]

To determine whether the taxpayer's fixed dividends qualify for relief under the above rules and, if they do, to determine the extent of such relief by determining whether such dividends exceed the dividends "earned," the taxpayer's "actual rate of return" is first computed. The actual rate of return is the average annual amount of dividends received (or deemed received under section 305 or any other provision) during the period the taxpayer owned the stock, computed as a return on the taxpayer's adjusted basis or, if lesser, the stock's liquidation preference.

If this actual rate of return exceeds 15 percent, no dividends are eligible for relief. Accordingly, the normal operation of the basic rule requires reduction of basis for any otherwise extraordinary dividends declared, announced, or agreed to within the 2-year holding period.

On the other hand, if the actual rate of return does not exceed 15 percent, relief may be available for otherwise qualified preferred dividends. If the stock is held more than 5 years, no basis reduction is required for such dividends. Even if the stock is held less than 5 years, no basis reduction is required if the actual rate of return does not exceed the stated rate of return, because the taxpayer is not considered to have received more dividends than it "earned." However, if the stock is held less than 5 years and the actual rate of return during the entire holding period exceeds the stated rate, a basis reduction will occur, but limiting the extraordinary dividend amount that would otherwise require basis reduction to the aggregate "excess" amount of dividends for the entire holding period. The required basis reduction will thus be the lesser of: (a) the full amount required under the basic rule with respect to the dividends that do not satisfy the 2-year holding period; or (b) the amount required if the aggregate amount of excess dividends for the entire holding period (up to five years) is treated as being an extraordinary dividend declared, announced, or agreed to prior to the expiration of the 2-year holding period.

The following is an example of the general operation of the special qualifying preferred stock rule: assume that on January 1, 1987, a corporation purchases for $1,000 ten shares of preferred stock having a liquidation preference of $100 per share and paying only fixed preferred dividends of $6 per share to shareholders of record semi-annually on March 31 and September 30 of each year. The basic extraordinary dividend rule would generally require the taxpayer to reduce the basis in the stock by the untaxed portion of each dividend attributable to the period prior to the expiration of the two-year holding period (in this case, the first four dividends, or $24 per share). This is because a dividend equaling or exceeding 5 percent of adjusted basis (or fair market value, if shown to the satisfaction of the Secretary) paid semi-annually is an extraordinary dividend under the general rule.[19] However, the special rule will apply to the preferred stock. Under this provision, the taxpayer's stated rate of return per share is 12 percent per year ($12/$100). If the taxpayer sells the stock on October 1, 1988, (after holding the stock for 1.75 years) the taxpayer's actual rate of return would not have exceeded the stated rate of return if the taxpayer had received dividends up to $21 per share (12/100 x 1.75). However, the taxpayer has received dividends of $24 per share, for an actual rate of return per share of 13.7 percent ($24/$100 divided by 1.75). The amount by which the actual rate of return exceeds the stated rate of return is $3 per share. Accordingly, this amount of the total aggregate dividends ($30 total, or 12.5 percent of the aggregate total dividends) will be treated as an extraordinary dividend described in section 1059(a) and will require basis reduction. However, if the corporation does not sell the stock until January 1, 1989, its actual rate of return per share will be 12 percent ($24/$100 divided by 2.0). This does not exceed the stated dividend rate; accordingly, no portion of the qualified preferred dividends will be treated as an extraordinary dividend.

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[18] It is understood that liquidation preference for this purpose and for other purposes of the provision does not include dividend arrearages, if any.

[19] If the dividend were 3 percent paid quarterly, it would not be an extraordinary dividend under the general rule and no basis reduction would be required.

Under the Act the term "extraordinary dividend" is also expanded to include any distribution (without regard to the holding period for the stock) to a corporate shareholder in partial liquidation of the distributing corporation. Congress thus intended the nontaxed portion of any partial liquidation distribution that is treated as a dividend to reduce basis, without regard to whether the two-year holding period is otherwise satisfied and without regard to whether the distribution is less than the "threshold percentage" otherwise required for an extraordinary dividend. For this purpose, a distribution will be treated as in partial liquidation if it satisfies the requirements of section 302(e) of the Code. Since the determination whether a distribution is in partial liquidation is made at the corporate rather than the shareholder level, Congress intended that the Treasury Department will have the authority to require the distributing corporation to advise its shareholders (with notice to the Internal Revenue Service) as to the character of the distribution. This characterization will generally be binding on the shareholders.[20] The Internal Revenue Service, however, will be free to challenge the characterization of the distribution, provided it takes a consistent position with respect to corporate and noncorporate shareholders.

Finally, under the Act the term "extraordinary dividend" includes any redemption of stock that is non-pro rata (again, without regard to the holding period of the stock or the relative size of the distribution). Congress thus intended the nontaxed portion of any non-pro rata redemption that is treated as a dividend to reduce basis, without regard to whether the two-year holding period is otherwise satisfied and without regard to whether the distribution is less than the "threshold percentage" otherwise required for an extraordinary dividend.

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[20] Congress intended that there will be a presumption, rebuttable by clear and convincing evidence, that this characterization of the distribution is correct. Congress anticipated that the Treasury Department may require the taxpayer to disclose on its return the fact that it is taking a contrary position and its reasons for doing so.

Under a special relief provision, a distribution that would otherwise constitute an extraordinary dividend is not considered to be extraordinary if the distributee has held the stock for the entire period the distributing corporation (and any predecessor corporation) has been in existence, the earnings and profits of the corporation were accumulated only during such period, and the application of this exception to the dividend is not inconsistent with the purposes of the extraordinary dividend rules. This relief provision was intended to permit distributions without basis reduction, even though the distributions exceed the threshold percentage and are declared, announced or agreed to within the 2-year holding period, only in those cases in which the earnings and profits from which the dividend is paid could not have been attributable to any person other than the original shareholder receiving the distribution. For this purpose, earnings and profits would not be considered attributable solely to such shareholder if any more than de minimis part of such earnings and profits is derived, directly or indirectly, from any other entity in which the shareholder was not an original shareholder with an interest at least as great as such shareholder's original and continuing interest in the distributing corporation at the time of the distribution.

Thus, for example, the relief provision would not apply if any more than a de minimis part of the earnings and profits from which the dividend is paid were derived (e.g., by distribution or by a transaction described in sec. 381) directly or indirectly from another corporation in which the original shareholder did not at all times hold at least as great an interest as such shareholder's interest in the distributing corporation at the time of the distribution.

However, the fact that the distributing corporation directly or indirectly received de minimis amounts of earnings and profits from other entities (such as non-extraordinary dividends received from temporary portfolio investments of funds), would not generally be expected to preclude the application of the relief provision.

For similar reasons, due to Congress' expectation that earnings and profits would be solely attributable to the distributee shareholders, the extraordinary dividend provision generally would not apply to distributions that constitute qualifying dividends within the meaning of section 243(b)(1), or to similar distributions between members of an affiliated group filing a consolidated return. Also, to the extent the consolidated return regulations would require basis reduction in any event, the provision would not simultaneously apply to dividend distributions (or deemed dividend distributions) between members of an affiliated group filing consolidated returns.

In order to prevent double inclusions in earnings and profits, Congress expected that the amount, if any, of earnings and profits resulting from gain on the disposition of stock shall be determined without regard to the basis adjustments made under this section.

Effective Date

The provision is generally effective for dividends declared after July 18, 1986. However, distributions constituting extraordinary dividends by virtue of being a distribution in partial liquidation or a non-pro rata distribution are subject to the provision only if announced or declared after October 22, 1986 (the date of enactment).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $32 million in 1987, $55 million in 1988, $57 million in 1989, $60 million in 1990, and $63 million in 1991.

F. Special Limitations on Net Operating Loss and Other Carryforwards (Sec. 621 of the Act and secs. 382 and 383 of the Code)[21]

Prior Law

Overview

In general, a corporate taxpayer is allowed to carry a net operating loss ("NOL(s)") forward for deduction in a future taxable year, as long as the corporation's legal identity is maintained. After certain nontaxable asset acquisitions in which the acquired corporation goes out of existence, the acquired corporation's NOL carryforwards are inherited by the acquiring corporation. Similar rules apply to tax attributes other than NOLs, such as net capital losses and unused tax credits. Historically, the use of NOL and other carryforwards has been subject to special limitations after specified transactions involving the corporation in which the carryforwards arose (referred to as the "loss corporation"). Prior law also provided other rules that were intended to limit tax-motivated acquisitions of loss corporations.

The operation of the special limitations on the use of carryforwards turned on whether the transaction that caused the limitations to apply took the form of a taxable sale or exchange of stock in the loss corporation or one of certain specified tax-free reorganizations in which the loss corporation's tax attributes carried over to a corporate successor. After a purchase (or other taxable acquisition) of a controlling stock interest in a loss corporation, NOL and other carryforwards were disallowed unless the loss corporation continued to conduct its historical trade or business. In the case of a tax-free reorganization, NOL and other carryforwards were generally allowed in full if the loss corporation's shareholders received stock representing at least 20 percent of the value of the acquiring corporation.

NOL and other carryforwards

Although the Federal income tax system generally requires an annual accounting, a corporate taxpayer was allowed to carry NOLs back to the three taxable years preceding the loss and then forward to each of the 15 taxable years following the loss year (sec. 172). The rationale for allowing the deduction of NOL carryforwards (and carrybacks) was that a taxpayer should be able to average income and losses over a period of years to reduce the disparity between the taxation of businesses that have stable income and businesses that experience fluctuations in income.[22]

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[21] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 321; H. Rep. 99-426, pp. 250-273; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 621; S.Rep. 99-313, pp. 224-248; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 170-196 (Conference Report).

[22] H.R. Rep. No. 1337, 83d Cong., 2d sess. 27 (1954).

In addition to NOLs, other tax attributes eligible to be carried back or forward include unused investment tax credits (secs. 30 and 39), excess foreign tax credits (sec. 904(c)), and net capital losses (sec. 1212). Like NOLs, unused investment tax credits were allowed a three-year carryback and a 15-year carryforward. Subject to an overall limitation based on a taxpayer's U.S. tax attributable to foreign-source income, excess foreign tax credits were allowed a two-year carryback and a five-year carryforward. For net capital losses, generally, corporations had a three-year carryback (but only to the extent the carrybacks did not increase or create a NOL) and a five-year carryforward.

NOL and other carryforwards that were not used before the end of a carryforward period expired.

Carryovers to corporate successors

In general, a corporation's tax history (e.g., carryforwards and asset basis) was preserved as long as the corporation's legal identity was continued. Thus, under the general rules of prior law, changes in the stock ownership of a corporation did not affect the corporation's tax attributes. Following are examples of transactions that effected ownership changes without altering the legal identity of a corporation:

(1) A taxable purchase of a corporation's stock from its shareholders (a "purchase"),

(2) A type "B" reorganization, in which stock representing control of the acquired corporation is acquired solely in exchange for voting stock of the acquiring corporation (or a corporation in control of the acquiring corporation) (sec. 368(a)(1)(B)),

(3) A transfer of property to a corporation after which the transferors own 80 percent or more of the corporation's stock (a "section 351 exchange"),

(4) A contribution to the capital of a corporation, in exchange for the issuance of stock, and

(5) A type "E" reorganization, in which interests of investors (shareholders and bondholders) are restructured (sec. 368(a)(1)(E)).

Statutory rules also provided for the carryover of tax attributes (including NOL and other carryforwards) from one corporation to another in certain tax-free acquisitions in which the acquired corporation went out of existence (sec. 381). These rules applied if a corporation's assets were acquired by another corporation in one of the following transactions:

(1) The liquidation of an 80-percent owned subsidiary (sec. 332),

(2) A statutory merger or consolidation, or type "A" reorganization (sec. 368(a)(1)(A)),

(3) A type "C" reorganization, in which substantially all of the assets of one corporation is transferred to another corporation in exchange for voting stock, and the transferor completely liquidates (sec. 368(a)(1)(C)),

(4) A "nondivisive D reorganization," in which substantially all of a corporation's assets are transferred to a controlled corporation, and the transferor completely liquidates (secs. 368(a)(1)(D) and 354(b)(1)),

(5) A mere change in identity, form, or place of organization of a single corporation, or type "F" reorganization (sec. 368(a)(1)(F)), and

(6) A type "G" reorganization, in which substantially all of a corporation's assets are transferred to another corporation pursuant to a court approved insolvency or bankruptcy reorganization plan, and stock or securities of the transferee are distributed pursuant to the plan (sec. 368(a)(1)(G)).

In general, to qualify an acquisitive transaction (including a B reorganization) as a tax-free reorganization, the shareholders of the acquired corporation had to retain "continuity of interest." Thus, a principal part of the consideration used by the acquiring corporation had to consist of stock, and the holdings of all shareholders had to be traced. Further, a tax-free reorganization was required to satisfy a "continuity of business enterprise" test. Generally, continuity of business enterprise requires that a significant portion of an acquired corporation's assets be used in a business activity (*see* Treas. reg. sec. 1.368-1(d)).

Acquisitions to evade or avoid income tax

The Secretary of the Treasury was authorized to disallow deductions, credits, or other allowances following an acquisition of control of a corporation or a tax-free acquisition of a corporation's assets if the principal purpose of the acquisition was tax avoidance (sec. 269). This provision applied in the following cases:

(1) where any person or persons acquired (by purchase or in a tax-free transaction) at least 50 percent of a corporation's voting stock, or stock representing 50 percent of the value of the corporation's outstanding stock;

(2) where a corporation acquired property from a previously unrelated corporation and the acquiring corporation's basis for the property was determined by reference to the transferor's basis; and

(3) where a corporation purchased the stock of another corporation in a transaction that qualified for elective treatment as a direct asset purchase (sec. 338), a section 338 election was not made, and the acquired corporation was liquidated into the acquiring corporation (under sec. 332).

Treasury regulations under section 269 provided that the acquisition of assets with an aggregate basis that is materially greater than their value (i.e., assets with built-in losses), coupled with the utilization of the basis to create tax-reducing losses, is indicative of a tax-avoidance motive (Treas. reg. sec. 1.269-3(c)(1)).

Consolidated return regulations

To the extent that NOL carryforwards were not limited by the application of section 382 or section 269, after an acquisition, the use of such losses might be limited under the consolidated return regulations. In general, if an acquired corporation joined the acquiring corporation in the filing of a consolidated tax return by an affiliated group of corporations, the use of the acquired corporation's pre-acquisition NOL carryforwards against income generated by other members of the group was limited by the "separate return limitation year" ("SRLY") rules (Treas. reg. sec. 1.1502-21(c)). An acquired corporation was permitted to use pre-acquisition NOLs only up to the amount of its own contribution to the consolidated group's taxable income. Section 269 was available to prevent taxpayers from avoiding the SRLY rules by diverting income-producing activities (or contributing income-producing assets) from elsewhere in the group to a newly acquired corporation (see Treas. reg. sec. 1.269-3(c)(2), to the effect that the transfer of income-producing assets by a parent corporation to a loss subsidiary filing a separate return may be deemed to have tax avoidance as a principal purpose).

Applicable Treasury regulations provided rules to prevent taxpayers from circumventing the SRLY rules by structuring a transaction as a "reverse acquisition" (defined in regulations as an acquisition where the "acquired" corporation's shareholders end up owning more than 50 percent of the value of the "acquiring" corporation) (Treas. reg. sec. 1.1502-75(d)(3)). Similarly, under the "consolidated return change of ownership" ("CRCO") rules, if more than 50 percent of the value of stock in the common parent of an affiliated group changed hands, tax attributes (such as NOL carryforwards) of the group were limited to use against post-acquisition income of the members of the group (Treas. reg. sec. 1.1502-21(d)).

Treasury regulations also prohibited the use of an acquired corporation's built-in losses to reduce the taxable income of other members of an affiliated group (Treas. reg. sec. 1.1502-15). Under the regulations, built-in losses were subject to the SRLY rules. In general, built-in losses were defined as deductions or losses that economically accrued prior to the acquisition but were recognized for tax purposes after the acquisition, including depreciation deductions attributable to a built-in loss (Treas. reg. sec. 1.1502-15(a)(2)). The built-in loss limitations did not apply unless, among other things, the aggregate basis of the acquired corporation's assets (other than cash, marketable securities, and goodwill) exceeded the value of those assets by more than 15 percent.

Allocation of income and deductions among related taxpayers

The Secretary of the Treasury was authorized to apportion or allocate gross income, deductions, credits, or allowances, between or among related taxpayers (including corporations), if such action was necessary to prevent evasion of tax or to clearly reflect the income of a taxpayer (sec. 482). Section 482 could apply to prevent the diversion of income to a loss corporation in order to absorb NOL carryforwards.

Libson Shops doctrine

In *Libson Shops v. Koehler*, 353 U.S. 382 (1957) (decided under the 1939 Code), the U.S. Supreme Court adopted a test of business continuity for use in determining the availability of NOL carryovers. The court denied NOL carryovers following the merger of 16 identically owned corporations (engaged in the same business at different locations) into one corporation, on the ground that the business generating post-merger income was not substantially the same business that incurred the loss (three corporations that generated the NOL carryovers continued to produce losses after the merger).

There was uncertainty whether the *Libson Shops* doctrine had continuing application as a separate nonstatutory test under the 1954 Code. Compare *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965) (holding that *Libson Shops* is inapplicable to years governed by the 1954 Code) with Rev. Rul. 63-40, 1963-1 C.B. 46, as modified by T.I.R. 773 (October 13, 1965) (indicating that *Libson Shops* may have continuing vitality where, inter alia, there is a shift in the "benefits" of an NOL carryover).[23]

1954 Code special limitations

The application of the special limitations on NOL carryforwards was triggered under the 1954 Code by specified changes in stock ownership of the loss corporation (sec. 382). In measuring changes in stock ownership, section 382(c) specifically excluded "nonvoting stock which is limited and preferred as to dividends." Different rules were provided for the application of special limitations on the use of carryovers after a purchase and after a tax-free reorganization. Section 382 did not address the treatment of built-in losses.

If the principal purpose of the acquisition of a loss corporation was tax avoidance, section 269 would apply to disallow NOL carryforwards even if section 382 was inapplicable. Similarly, the SRLY rules could apply even if section 382 did not apply.

Taxable purchases

If the special limitations applied after a purchase, NOL carryforwards were disallowed entirely under the 1954 Code. The rule for purchases applied if (1) one or more of the loss corporation's ten largest shareholders increased their common stock ownership within a two-year period by at least 50 percentage points, (2) the change in stock ownership resulted from a purchase or a decrease in the amount of outstanding stock, and (3) the loss corporation failed to continue the conduct of a trade or business substantially the same as that conducted before the proscribed change in ownership (sec. 382(a)). An exception to the purchase rule was provided for acquisitions from related persons.

Tax-free reorganizations

After a tax-free reorganization to which section 382(b) applied, NOL carryovers were allowed in full under the 1954 Code so long as the loss corporation's shareholders received stock representing 20 percent or more of the value of the successor corporation (and section 269 did not apply). For each percentage point less than 20 percent received by the loss corporation's shareholders, the NOL carryover was reduced by five percent (e.g., if the loss corporation's shareholders received 15 percent of the acquiring corporation's stock, 25 percent of the NOL carryover was disallowed). The reorganizations described in section 382(b) were those referred to in section 381(a)(2), in which the loss corporation goes out of existence and NOL carryforwards carry over to a corporate successor. Where an acquiring corporation used stock of a parent corporation as consideration (in a triangular reorganization), the 20-percent test was applied by treating the loss corporation's shareholders as if they received stock of the acquiring corporation with an equivalent value, rather than stock of the parent corporation. An exception to the reorganization rule was provided for mergers of corporations that are owned substantially by the same persons in the same proportion (thus, the result in the *Libson Shops* case was reversed).

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[23] The legislative history of the 1976 Act amendments to section 382—discussed below—specifically provided that *Libson Shops* would have no application to years governed by those amendments. See S. Rep. 938, 94th Cong., 2d Sess. p. 206 (1976).

Bankruptcy proceedings and stock-for-debt exchanges

In the case of a G reorganization, a creditor who received stock in the reorganization was treated as a shareholder immediately before the reorganization. Thus, NOL carryforwards were generally available without limitation following changes in stock ownership resulting from a G reorganization.

If security holders exchanged securities for stock in a loss corporation, the transaction could qualify as an E reorganization or a section 351 exchange. If unsecured creditors (e.g., trade creditors) exchanged their debt claims for stock in a loss corporation, such creditors recognized gain or loss: (1) indebtedness of the transferee corporation not evidenced by a security was not considered as issued for property for purposes of section 351, and (2) the definition of an E reorganization required an exchange involving stock or securities. Thus, a stock-for-debt exchange by unsecured creditors was treated as a taxable purchase that triggered the special limitation.

Transactions involving "thrifts"

The general rules applied to taxable purchases of stock in a savings and loan association or savings bank (referred to as a "thrift"). Thus, after an ownership change resulting from a taxable purchase, a thrift's NOL carryforwards were unaffected if the thrift continued its business. Moreover, section 382 did not apply to a section 351 transfer to a thrift.

Where the acquisition of a thrift resulted from a reorganization described in section 368(a)(3)(D)(ii),[24] depositors were treated as stockholders and their deposits were treated as stock for purposes of the special limitations applicable to reorganizations (prior law sec. 382(b)(7)). Thus, a thrift's NOL carryforwards were unaffected if the depositors' interests (including the face amount of their deposits) represented at least 20 percent of the acquiring corporation's value after the merger.

Special limitations on other tax attributes

Section 383 incorporated by reference the same limitations contained in section 382 for carryforwards of investment credits, foreign tax credits, and capital losses.

1976 Act amendments

The Tax Reform Act of 1976 extensively revised section 382 to provide more nearly parallel rules for taxable purchases and tax-free reorganizations and to address technical problems arising under the 1954 Code. The 1976 Act amendments were to be effective in 1978; however, the effective date was delayed several times. The 1976 Act amendments to the rule for purchases technically became effective for taxable years beginning after December 31, 1985. The amended reorganization rules technically became effective for reorganizations pursuant to plans adopted on or after January 1, 1986.

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[24] Prior law section 368(a)(3)(D)(ii) provided nonrecognition treatment to thrift reorganizations that would otherwise qualify as G reorganizations, provided the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation ("FSLIC"), or an equivalent State authority certified that the thrift was insolvent, could not meet its obligations currently, or would be unable to meet its obligations in the immediate future.

Reasons for Change

The Act draws heavily on the recommendations regarding limitations on NOL carryforwards that were made by the Finance Committee Staff as part of its comprehensive final report regarding reform of subchapter C of the Internal Revenue Code. (*See* S. Prt. 99-47, 99th Cong., 1st Sess. (1985), "The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff").

Preservation of the averaging function of carryovers

The primary purpose of the special limitations is the preservation of the integrity of the carryover provisions. The carryover provisions perform a needed averaging function by reducing the distortions caused by the annual accounting system. If, on the other hand, carryovers can be transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment of losses through the tax system. Under such a system, the Federal Government would effectively be required to reimburse a portion of all corporate tax losses. Regardless of the merits of such a reimbursement program, the carryover rules appear to be an inappropriate and inefficient mechanism for delivery of the reimbursement.

Appropriate matching of loss to income

The 1976 Act amendments reflect the view that the relationship of one year's loss to another year's income should be largely a function of whether and how much the stock ownership changed in the interim, while the *Libson Shops* business continuation rule measures the relationship according to whether the loss and the income were generated by the same business. The Act acknowledges the merit in both approaches, while seeking to avoid the economic distortions and administrative problems that a strict application of either approach would entail.

A limitation based strictly on ownership would create a tax bias against sales of corporate businesses, and could prevent sales that would increase economic efficiency. For example, if a prospective buyer could increase the income from a corporate business to a moderate extent, but not enough to overcome the loss of all carryovers, no sale would take place because the business would be worth more to the less-efficient current owner than the prospective buyer would reasonably pay. A strict ownership limitation also would distort the measurement of taxable income generated by capital assets purchased before the corporation was acquired, if the tax deductions for capital costs economically allocable to post-acquisition years were accelerated into pre-acquisition years, creating carryovers that would be lost as a result of the acquisition.

Strict application of a business continuation rule would also be undesirable, because it would discourage efforts to rehabilitate troubled businesses. Such a rule would create an incentive to maintain obsolete and inefficient business practices if the needed changes would create the risk of discontinuing the old business for tax purposes, thus losing the benefit of the carryovers.

Permitting the carryover of all losses following an acquisition, as is permitted under the 1954 Code if the loss business is continued following a purchase, provides an improper matching of income and loss. Income generated under different corporate owners, from capital over and above the capital used in the loss business, is related to a pre-acquisition loss only in the formal sense that it is housed in the same corporate entity. Furthermore, the ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions. For example, a prospective buyer of a loss corporation might be a less efficient operator of the business than the current owner, but the ability to use acquired losses could make the loss corporation more valuable to the less efficient user and thereby encourage a sale.

Reflecting the policies described above, the Act addresses three general concerns: (1) the approach of prior law (viz., the disallowance or reduction of NOL and other carryforwards), which is criticized as being too harsh where there are continuing loss-corporation shareholders, and ineffective to the extent that NOL carryforwards may be available for use without limitation after substantial ownership changes, (2) the discontinuities in the prior law treatment of taxable purchases and tax-free reorganizations, and (3) defects in the prior law rules that presented opportunities for tax avoidance.

General approach

After reviewing various options for identifying events that present the opportunity for a tax benefit transfer (*e.g.*, changes in a loss corporation's business), it was concluded that changes in a loss corporation's stock ownership continue to be the best indicator of a potentially abusive transaction. Under the Act, the special limitations generally apply when shareholders who bore the economic burden of a corporation's NOLs no longer hold a controlling interest in the corporation. In such a case, the possibility arises that new shareholders will contribute income-producing assets (or divert income opportunities) to the loss corporation, and the corporation will obtain greater utilization of carryforwards than it could have had there been no change in ownership.

To address the concerns described above, the Act adopts the following approach: After a substantial ownership change, rather than reducing the NOL carryforward itself, the earnings against which an NOL carryforward can be deducted are limited. This general approach has received wide acceptance among tax scholars and practitioners. This "limitation on earnings" approach is intended to permit the survival of NOL carryforwards after an acquisition, while limiting the ability to utilize the carryforwards against unrelated income.

The limitation on earnings approach is intended to approximate the results that would occur if a loss corporation's assets were combined with those of a profitable corporation in a partnership. This treatment can be justified on the ground that the option of contributing assets to a partnership is available to a loss corporation. In such a case, only the loss corporation's share of the partnership's income could be offset by the corporation's NOL carryforward. Presumably, except in the case of tax-motivated partnership agreements, the loss corporation's share of the partnership's income would be limited to earnings generated by the assets contributed by the loss corporation.

For purposes of determining the income attributable to a loss corporation's assets, the Act prescribes an objective rate of return on the value of the corporation's equity. Consideration was given to the arguments made in favor of computing the prescribed rate of return by reference to the gross value of a loss corporation's assets, without regard to outstanding debt. It was concluded that it would be inappropriate to permit the use of NOL carryforwards to shelter earnings that are used (or would be used in the absence of an acquisition) to service a loss corporation's debt. The effect of taking a loss corporation's gross value into account would be to accelerate the rate at which NOL carryforwards would be used had there been no change in ownership, because interest paid on indebtedness is deductible in its own right (thereby deferring the use of a corresponding amount of NOLs). There is a fundamental difference between debt capitalization and equity capitalization: true debt represents a claim against a loss corporation's assets.

Annual limitation

The annual limitation on the use of pre-acquisition NOL carryforwards is the product of the prescribed rate and the value of the loss corporation's equity immediately before a proscribed ownership change. The average yield for long-term marketable obligations of the U.S. government was selected as the measure of a loss corporation's expected return on its assets.

The rate prescribed by the Act is higher than the average rate at which loss corporations actually absorb NOL carryforwards. Indeed, many loss corporations continue to experience NOLs, thereby increasing—rather than absorbing—NOL carryforwards. On the other hand, the adoption of the average absorption rate may be too restrictive for loss corporations that out-perform the average. Therefore, it would be inappropriate to set a rate at the lowest rate that is theoretically justified. The use of the long-term rate for Federal obligations was justified as a reasonable risk-free rate of return a loss corporation could obtain in the absence of a change in ownership.

Anti-abuse rules

The mechanical rules described above could present unintended tax-planning opportunities and might foster certain transactions that many would perceive to be violative of the legislative intent. Therefore, the Act includes several rules that are designed to prevent taxpayers from circumventing the special limitations or otherwise appearing to traffic in loss corporations by (1) reducing a loss corporation's assets to cash or other passive assets and then selling off a corporate shell consisting primarily of NOLs and cash or other passive assets, or (2) making pre-acquisition infusions of assets to inflate artificially a loss corporation's value (and thereby accelerate the use of NOL carryforwards). In addition, the Act retains the prior law principles that are intended to limit tax-motivated acquisitions of loss corporations (*e.g.*, section 269, relating to acquisitions to evade or avoid taxes, and the regulatory SRLY and CRCO rules).

Consideration also was given to transactions in which taxpayers effectively attempt to purchase the NOLs of a loss corporation by the use of a partnership in which the loss corporation, as a partner, is allocated a large percentage of taxable income for a limited time period. During this time, the NOL partner's losses are expected to shelter the partnership's income while the cash flow from the partnership's assets is used for other purposes. Later the NOL partner's share of income is reduced. When all the facts and circumstances are considered, including the arrangements and actual transactions with respect to capital accounts, it often appears to be questionable whether the economic benefit that corresponds to the initial special allocation to the NOL partner is fully received by such partner. Nevertheless, some taxpayers take the position that such allocations have substantial economic effect under section 704(b). The Act contemplates that the Treasury Department will review this situation under section 704(b).

The Act provides that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of section 382 through the use of related parties, pass-through entities, or other intermediaries. For example, regardless of whether a special allocation has substantial economic effect under section 704(b), special allocations of income to a loss partner, or other arrangements shifting taxable income, will not be permitted to result in a greater use of losses than would occur if the principles of section 382 were applied to the arrangement.

Technical problems

The Act addresses the technical problems of prior law by (1) coordinating the rules for taxable purchases with the rules for tax-free transactions, (2) expanding the scope of the rules to cover economically similar transactions that effect ownership changes (such as capital contributions, section 351 exchanges, and B reorganizations), (3) refining the definition of the term "stock," and (4) applying the special limitations to built-in losses and taking into account built-in gains.

Discontinuities

Because the 1954 Code threshold for purchases was 50 percent, but the threshold for reorganizations was 20 percent, those rules presented the possibility that economically similar transactions would receive disparate tax treatment. Further, the special limitations applied after a purchase only if a pre-acquisition trade or business was discontinued, while the reorganization rule looked solely to changes in ownership. Finally, if the purchase rule applied, all NOL carryforwards were disallowed. In contrast, the rule for reorganizations merely reduced NOL carryforwards in proportion to the ownership change. The Act eliminates such discontinuities.

Continuity-of-business enterprise

The requirement under the 1954 Code rules that a loss corporation continue substantially the same business after a purchase presented potentially difficult definitional issues. Specifically, taxpayers and the courts were required to determine at what point a change in merchandise, location, size, or the use of assets should be treated as a change in the loss corporation's business. It was also difficult to identify a particular business where assets and activities were constantly combined, separated, or rearranged. Further, there was a concern that the prior law requirement induced taxpayers to continue uneconomic businesses.

The Act eliminates the business-continuation rule. The continuity-of-business-enterprise rule generally applicable to tax-free reorganizations also applies to taxable transactions.

Participating stock

The Act addresses the treatment of transactions in which the beneficial ownership of an NOL carryforward does not follow stock ownership. This problem is illustrated by the case of *Maxwell Hardware Co.*, in which a loss corporation's old shareholders retained common stock representing more than 50 percent of the corporation's value, but new shareholders received specially tailored preferred stock that carried with it a 90-percent participation in the corporation's earnings attributable to income-producing assets contributed by the new shareholders.[25]

Built-in gains and losses

Built-in losses should be subject to special limitations because they are economically equivalent to pre-acquisition NOL carryforwards. If built-in losses were not subject to limitations, taxpayers could reduce or eliminate the impact of the general rules by causing a loss corporation (following an ownership change) to recognize its built-in losses free of the special limitations (and then invest the proceeds in assets similar to the assets sold).

The Act also provides relief for loss corporations with built-in gain assets. Built-in gains are often the product of special tax provisions that accelerate deductions or defer income (e.g., accelerated depreciation or installment sales reporting). Absent a special rule, the use of NOL carryforwards to offset built-in gains recognized after an acquisition would be limited, even though the carryforwards would have been fully available to offset such gains had the gains been recognized before the change in ownership occurred. (Similarly, a partnership is required to allocate built-in gain or loss to the contributing partner.)

Although the special treatment of built-in gains and losses may require valuations of a loss corporation's assets, the Act limits the circumstances in which valuations will be required by providing a generous de minimis rule.

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[25] 343 F.2d 713 (9th Cir. 1965).

Other technical gaps

The Act also corrects the following defects in the 1954 Code rules: (1) only NOL deductions from prior taxable years were limited; thus, NOLs incurred in the year of a substantial ownership change were unaffected, (2) the rule for purchases was inapplicable to ownership changes resulting from section 351 exchanges, capital contributions, the liquidation of a partner's interest in a partnership that owns stock in a loss corporation, and nontaxable acquisitions of interests in a partnership (e.g., by contribution) that owns stock in a loss corporation, (3) the reorganization rule was inapplicable to B reorganizations, (4) the measurement of the continuing interest of a loss corporation's shareholders after a triangular reorganization enabled taxpayers to circumvent the 20-percent-continuity-of-interest rule, and (5) taxpayers took the position that the reorganization rule did not apply to reverse mergers (where an acquiring corporation's subsidiary merged into a loss corporation and the loss corporation's shareholders received stock of the acquiring corporation in the exchange).

Insolvent corporations

Under the general rule of the Act, no carryforwards would be usable after the acquisition of an insolvent corporation because the corporation's value immediately before the acquisition would be zero. In such a case, however, the loss corporation's creditors are the true owners of the corporation, although it may be impossible to identify the point in time when ownership shifted from the corporation's shareholders.[26] Relief from a strict application of the general rule is provided, as the creditors of an insolvent corporation frequently have borne the losses reflected in an NOL carryforward. There was a concern, however, about the potential for abusive transactions if an exception were generally available. For example, if there were a general stock-for-debt exception, an acquiring corporation could purchase a loss corporation's debt immediately before or during a bankruptcy proceeding, exchange the debt for stock without triggering the special limitations, and then use the loss corporation's NOL carryforwards immediately and without limitation. Alternatively, an acquiring corporation could purchase stock from the creditors after the bankruptcy proceeding, and after the loss corporation's value has been increased by capital contributions.

For these reasons, the Act provides an exception for ownership changes that occur as part of a G reorganization or a stock-for-debt exchange in a Title 11 or similar proceeding, but includes appropriate safeguards intended to limit tax-motivated acquisitions of debt issued by loss corporations.

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[26] *Cf. Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) ("When the equity owners are excluded and the old creditors become the stockholders . . ., it conforms to reality to date [the creditors] equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority").

Explanation of Provisions

Overview

The Act alters the character of the special limitations on the use of NOL carryforwards. After an ownership change, as described below, the taxable income of a loss corporation available for offset by pre-acquisition NOL carryforwards is limited annually to a prescribed rate times the value of the loss corporation's stock immediately before the ownership change. In addition, NOL carryforwards are disallowed entirely unless the loss corporation satisfies continuity-of-business enterprise requirements for the two-year period following any ownership change. The Act also expands the scope of the special limitations to include built-in losses and allows loss corporations to take into account built-in gains. The Act includes numerous technical changes and several anti-avoidance rules. Finally, the Act applies similar rules to carryforwards other than NOLs, such as net capital losses and excess foreign tax credits.

Ownership change

The special limitations apply after any ownership change. An ownership change occurs, in general, if the percentage of stock of the new loss corporation owned by any one or more 5-percent shareholders (described below) has increased by more than 50 percentage points relative to the lowest percentage of stock of the old loss corporation owned by those 5-percent shareholders at any time during the testing period (generally a three-year period) (new sec. 382(g)(1)).[27] The determination of whether an ownership change has occurred is made by aggregating the increases in percentage ownership for each 5-percent shareholder whose percentage ownership has increased during the testing period. For this purpose, all stock owned by persons who own less than five percent of a corporation's stock generally is treated as stock owned by a single 5-percent shareholder (new sec. 382(g)(4)(A)). The determination of whether an ownership change has occurred is made after any owner shift involving a 5-percent shareholder or any equity structure shift.

Determinations of the percentage of stock in a loss corporation owned by any person are made on the basis of value. Except as provided in regulations to be prescribed by the Secretary, changes in proportionate ownership attributable solely to fluctuations in the relative fair market values of different classes of stock are not taken into account (new sec. 382(l)(3)(D)).

In determining whether an ownership change has occurred, changes in the holdings of certain preferred stock are disregarded. Except as provided in regulations, all "stock" (not including stock described in section 1504(a)(4)) is taken into account (new sec. 382(k)(6)(A)). Under this standard, the term stock does not include stock that (1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights that do not exceed the stock's issue price upon issuance (except for a reasonable redemption premium), and (4) is not convertible to any other class of stock. If preferred stock carries a dividend rate materially in excess of a market rate, this may indicate that it would not be disregarded.

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[27] Unless specifically identified as a taxable year, all references to any period constituting a year (or multiple thereof) means a 365-day period (or multiple thereof).

Under grants of regulatory authority, the Treasury Department is expected to publish regulations disregarding, in appropriate cases, certain stock that would otherwise be counted in determining whether an ownership change has occurred, when necessary to prevent avoidance of the special limitations (new sec. 382(k)(6)(B)). For example, it may be appropriate to disregard preferred stock (even though voting) or common stock where the likely percentage participation of such stock in future corporate growth is disproportionately small compared to the percentage value of the stock as a proportion of total stock value, at the time of the issuance or transfer. Similarly, there is a concern that the inclusion of voting preferred stock (which is not described in section 1504(a)(4) solely because it carries the right to vote) in the definition of stock presents the potential for avoidance of section 382. As another example, stock such as that issued to the old loss company shareholders and retained by them in the case of *Maxwell Hardware Company* v. *Commissioner,* 343 F.2d 716 (9th Cir. 1969), is not intended to be counted in determining whether an ownership change has occurred.

In addition, the Treasury Department will promulgate regulations regarding the extent to which stock that is not described in section 1504(a)(4) should nevertheless not be considered stock. For example, the Treasury Department may issue regulations providing that preferred stock otherwise described in section 1504(a)(4) will not be considered stock simply because the dividends are in arrears and the preferred shareholders thus become entitled to vote.

Owner shift involving a 5-percent shareholder

An owner shift involving a 5-percent shareholder is defined as any change in the respective ownership of stock of a corporation that affects the percentage of stock held by any person who holds five percent or more of the stock of the corporation (a "5-percent shareholder") before or after the change (new sec. 382(g)(2)). For purposes of this rule, all less-than-5-percent shareholders are aggregated and treated as one 5-percent shareholder. Thus, an owner shift involving a 5-percent shareholder includes (but is not limited to) the following transactions:

(1) A taxable purchase of loss corporation stock by a person who holds at least five percent of the stock before the purchase;

(2) A disposition of stock by a person who holds at least five percent of stock of the loss corporation either before or after the disposition;

(3) A taxable purchase of loss corporation stock by a person who becomes a 5-percent shareholder as a result of the purchase;

(4) A section 351 exchange that affects the percentage of stock ownership of a loss corporation by one or more 5-percent shareholders;

(5) A decrease in the outstanding stock of a loss corporation (*e.g.,* by virtue of a redemption) that affects the percentage of stock own-

ership of the loss corporation by one or more 5-percent shareholders;

(6) A conversion of debt (or pure preferred stock that is excluded from the definition of stock) to stock where the percentage of stock ownership of the loss corporation by one or more 5-percent shareholders is affected; and

(7) An issuance of stock by a loss corporation that affects the percentage of stock ownership by one or more 5-percent shareholders.

Example 1.—The stock of L corporation is publicly traded; no shareholder holds five percent or more of L stock. During the three-year period between January 1, 1987 and January 1, 1990, there are numerous trades involving L stock. No ownership change will occur as a result of such purchases, provided that no person (or persons) becomes a 5-percent shareholder, either directly or indirectly, and increases his (or their) ownership of L stock by more than 50 percentage points.

Example 2.—On January 1, 1987, the stock of L corporation is publicly traded; no shareholder holds five percent or more of L stock. On September 1, 1987, individuals A, B, and C, who were not previously L shareholders and are unrelated to each other or any L shareholders, each acquire one-third of L stock. A, B, and C each have become 5-percent shareholders of L and, in the aggregate, hold 100 percent of the L stock. Accordingly, an ownership change has occurred, because the percentage of L stock owned by the three 5-percent shareholders after the owner shift (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by A, B, and C at any time during the testing period (0 percent prior to September 1, 1987).

Example 3.—On January 1, 1987, individual I owns all 1,000 shares of corporation L. On June 15, 1987, I sells 300 of his L shares to unrelated individual A. On June 15, 1988, L issues 100 shares to each of B, C, and D. After these owner shifts involving I, A, B, C, and D, each of whom is a 5-percent shareholder, there is no ownership change, because the percentage of stock owned by A, B, C, and D after the owner shifts (approximately 46 percent—A-23 percent; B, C, and D-7.7 percent each) has not increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders during the testing period (0 percent prior to June 15, 1987). On December 15, 1988, L redeems 200 of the shares owned by I. Following this owner shift affecting I, a 5-percent shareholder, there is an ownership change, because the percentage of L stock owned by A, B, C, and D (approximately 55 percent—A-27.3 percent; B, C, and D-9.1 percent each) has increased by more than 50 percentage points over the lowest percentage owned by those shareholders during the testing period (0 percent prior to June 15, 1987).

Example 4.—L corporation is closely held by four unrelated individuals, A, B, C, and D. On January 1, 1987, there is a public offering of L stock. No person who acquires stock in a public offering acquires five percent or more, and neither A, B, C, nor D acquires any additional stock. As a result of the offering, less-than-5-percent shareholders own stock representing 80 percent of the outstanding L stock. The stock ownership of the less-than-5-percent shareholders are aggregated and treated as owned by a single 5-percent shareholder for purposes of determining whether an ownership change has occurred. The percentage of stock owned by the less-than-5-percent shareholders after the owner shift (80 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the testing period (0 percent prior to January 1, 1987). Thus, an ownership change has occurred.

Example 5.—On January 1, 1987, L corporation is wholly owned by individual X. On January 1, 1988, X sells 50 percent of his stock to 1,000 shareholders, all of whom are unrelated to him. On January 1, 1989, X sells his remaining 50-percent interest to an additional 1,000 shareholders, all of whom also are unrelated to him. Based on these facts, there is not an ownership change immediately following the initial sales by X, because the percentage of L stock owned by the group of less-than-5-percent shareholders (who are treated as a single 5-percent shareholder) after the owner shift (50 percent) has not increased by *more* than 50 percentage points over the lowest percentage of stock owned by this group at any time during the testing period (0 percent prior to January 1, 1988). On January 1, 1989, however, there is an ownership change, because the percentage of L stock owned by the group of less-than-5-percent shareholders after the owner shift (100 percent) has increased by more than 50 percentage points over their lowest percentage ownership at any time during the testing period (0 percent prior to January 1, 1988).

Example 6.—The stock of L corporation is publicly traded; no shareholder owns five percent or more. On January 1, 1987, there is a stock offering as a result of which stock representing 60 percent of L's value is acquired by an investor group consisting of 12 unrelated individuals, each of whom acquires five percent of L stock. Based on these facts, there has been an ownership change, because the percentage of L stock owned after the owner shift by the 12 5-percent shareholders in the investor group (60 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the testing period (0 percent prior to January 1, 1987).

Example 7.—On January 1, 1987, L corporation is owned by two unrelated shareholders, A (60 percent) and C (40 percent). LS corporation is a wholly owned subsidiary of L corporation and is therefore deemed to be owned by A and C in the same proportions as their ownership of L (after application of the attribution rules, as discussed below). On January 1, 1988, L distributes all the stock of LS to A in exchange for all of A's L stock in a section 355 transaction. There has been an ownership change of L, because the percentage of L stock owned by C (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by C at any time during the testing period (40 percent prior to the distribution of LS stock). There has not been an ownership change of LS, because the percentage of LS stock owned by A (100 percent) has not increased by more than 50 percentage points over the lowest percentage of stock owned by A at any time during the testing period (60 percent, after application of the attribution rules, as discussed below), prior to January 1, 1988.

Equity structure shift

An equity structure shift is defined as any tax-free reorganization within the meaning of section 368, other than a divisive "D" or "G" reorganization or an "F" reorganization (new sec. 382(g)(3)(A)). In addition, to the extent provided in regulations, the term equity structure shift may include other transactions, such as public offerings not involving a 5-percent shareholder or taxable reorganization-type transactions (*e.g.*, mergers or other reorganization-type transactions that do not qualify for tax-free treatment due to the nature of the consideration or the failure to satisfy any of the other requirements for a tax-free transaction) (new secs. 382(g)(3)(B), (g)(4), and (m)(5)).[28] A purpose of the provision that considers only owner shifts involving a 5-percent shareholder is to relieve widely held companies from the burden of keeping track of trades among less-than-5-percent shareholders. For example, a publicly traded company that is 60 percent owned by less-than-5-percent shareholders would not experience an ownership change merely because, within a three-year period, every one of such shareholders sold his stock to a person who was not a 5-percent shareholder. There are situations involving transfers of stock involving less-than-5-percent shareholders, other than tax-free reorganizations (for example, public offerings), in which it will be feasible to identify changes in ownership involving such shareholders, because, unlike public trading, the changes occur as part of a single, integrated transaction. Where identification is reasonably feasible or a reasonable presumption can be applied, the Treasury Department is expected to treat such transactions under the rules applicable to equity structure shifts.

For purposes of determining whether an ownership change has occurred following an equity structure shift, the less-than-5-percent shareholders of each corporation that was a party to the reorganization will be segregated and treated as a single, separate 5-percent shareholder (new sec. 382(g)(4)(B)(i)). The Act contemplates that this segregation rule will similarly apply to acquisitions by groups of less-than-5 percent shareholders through corporations as well as other entities (*e.g.*, partnerships) and in transactions that do not constitute equity structure shifts (new sec. 382(g)(4)(C)). Moreover, the Act provides regulatory authority to apply similar segregation rules to segregate groups of less than 5-percent shareholders in cases that involve only a single corporation, (for example, a public offering or a recapitalization). (new sec. 382(m)(5)).

Example 8.—On January 1, 1988, L corporation (a loss corporation) is merged (in a transaction described in section 368(a)(1)(A)) into P corporation (not a loss corporation), with P surviving. Both L and P are publicly traded corporations with no shareholder owning five percent or more of either corporation or the surviving corporation. In the merger, L shareholders receive 30 percent of the stock of P. There has been an ownership change of L, because the percentage of P stock owned by the former P shareholders (all of whom are less-than-5-percent shareholders who are treated as a separate, single 5-percent shareholder) after the equity structure shift (70 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the merger). If, however, the former shareholders of L had received at least 50 percent of the stock of P in the merger, there would not have been an ownership change of L.

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[28] The regulatory authority provided by section 382(g)(3)(B) should not be construed to limit the scope of section 382(g)(4)(C), as augmented by section 382(m)(5). *See* discussion in text following Example 8, *supra*.

An ownership change would similarly occur after a taxable merger in which L acquires P (in which L's losses are not affected other than by the special limitations), if L's former shareholders receive only 30 percent of the combined company, pursuant to new section 382(g)(4)(C). The Congress expected that section 382(g)(4)(C) would by its terms generally cause the segregation of the less-than 5-percent shareholders of separate entities where an entity other than a single corporation is involved in a transaction. Section 382(g)(3)(B) and section 382(m)(5) provide additional authority for Treasury to segregate groups of less than 5 percent shareholders where there is only one corporation involved.

Example 9.—On January 1, 1987, L corporation is owned by two unrelated shareholders, A (60 percent) and C (40 percent). On January 1, 1988, L redeems all of A's L stock in exchange for non-voting preferred stock described in section 1504(a)(4). Following this recapitalization (which is both an equity structure shift and an owner shift involving a 5-percent shareholder), there has been an ownership change of L, because the percentage of L stock (which does not include preferred stock within the meaning of section 1504(a)(4)) owned by C following the equity structure shift (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by C at any time during the testing period (40 percent prior to the recapitalization).

Assume, alternatively, that on January 1, 1987, the stock of L corporation was widely held, with no shareholder owning as much as five percent, and that 60 percent of the stock was redeemed in exchange for non-voting preferred stock in a transaction that is otherwise identical to the transaction described above (which would be an equity structure shift, but not an owner shift involving a 5-percent shareholder because of the existence of only a single 5-percent shareholder, the aggregated less-than-5-percent shareholders, who owns 100 percent of L both before and after the exchange). In such a case, the Secretary will prescribe regulations segregating the less-than-5-percent shareholders of the single corporation, so that the group of shareholders who retain common stock in the recapitalization will be treated as a separate, single 5-percent shareholder. Accordingly, such a transaction would constitute an ownership change, because the percentage of L stock owned by the continuing common shareholders (100 percent) has increased by more than 50 percentage points over the lowest percent of stock owned by such shareholders at any time during the testing period (40 percent prior to the recapitalization).

Example 10.—L corporation stock is widely held; no shareholder owns as much as five percent of L stock. On January 1, 1988, L corporation, which has a value of $1 million, directly issues stock with a value of $2 million to the public; no one person acquired as much as five percent in the public offering. No ownership change has occurred, because a public offering in which no person acquires as much as five percent of the corporation's stock, however large, by a corporation that has no five-percent shareholder before the offering would not affect the percentage of stock owned by a 5-percent shareholder.[29] In other words, the percentage of stock owned by less-than-5-percent shareholders of L immediately after the public offering (100 percent) has not increased by more than 50 percentage points over the lowest percentage of stock owned by the less-than-5-percent shareholders of L at any time during the testing period (100 percent).

To the extent provided in regulations that will apply prospectively from the date the regulations are issued, a public offering can be treated, in effect, as an equity structure shift with the result that the offering is a measuring event, even if there is otherwise no change in ownership of a person who owns 5-percent of the stock before or after the transaction. Rules also would be provided to segregate the group of less-than-5-percent shareholders prior to the offering and the new group of less than-5-percent shareholders that acquire stock pursuant to the offering. Under such regulations, therefore, the less-than-5-percent shareholders who receive stock in the public offering could be segregated and treated as a separate 5-percent shareholder. Thus, an ownership change may result from the public offering described above, because the percentage of stock owned by the group of less-than-5-percent shareholders who acquire stock in the public offering, who are treated as a separate 5-percent shareholder (66.67 percent), has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the public offering). The Act contemplates that the regulations may provide rules to allow the corporation to establish the extent, if any, to which existing shareholders acquire stock in the public offering.

Multiple transactions

As described above, the determination of whether an ownership change has occurred is made by comparing the relevant shareholders' stock ownership immediately after either an owner shift involving a 5-percent shareholder or an equity structure shift with the lowest percentage of such shareholders' ownership at any time during the testing period. Thus, changes in ownership that occur by reason of a series of transactions including both owner shifts involving a 5-percent shareholder and equity structure shifts may constitute an ownership change. Where the segregation rule applies, for purposes of determining whether an ownership change has occurred as a result of any transaction, the acquisition of stock shall be treated as being made proportionately from all the shareholders immediately before the acquisition, unless a different proportion is established (new section 382(g)(4)(B)(ii) and (C)).

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[29] A different result would occur if the public offering were performed by an underwriter on a "firm commitment" basis, because the underwriter would be a 5-percent shareholder whose percentage of stock (66.67 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by the underwriter at any time during the testing period (0 percent prior to public offering). *See* Rev. Rul. 78-294, 1978-2 C.B. 141.

Example 11.—On January 1, 1988, I (an individual) purchased 40 percent of the stock of L. The remaining stock of L is owned by 25 shareholders, none of whom own as much as five percent. On July 1, 1988, L is merged into P—which is wholly owned by I—in a tax-free reorganization. In exchange for their stock in L, the L shareholders (immediately before the merger) receive stock with a value representing 60 percent of the P stock that is outstanding immediately after the merger (24 percent to I; 36 percent to the less-than-5-percent shareholders of L). No other transactions occurred with respect to L stock during the testing period preceding the merger. There is an ownership change with respect to L immediately following the merger, because the percentage of stock owned by I in the combined entity (64 percent—40 percent by virtue of I's ownership of P prior to the merger plus 24 percent received in the merger) has increased by more than 50 percentage points over the lowest percentage of stock in L owned by I during the testing period (0 percent prior to January 1, 1988).

Example 12.—On July 12, 1989, L corporation is owned 45 percent by P, a publicly traded corporation (with no 5-percent shareholders), 40 percent by individual A, and 15 percent by individual B. All of the L shareholders have owned their stock since L's organization in 1984. Neither A nor B owns any P stock. On July 30, 1989, B sells his entire 15-percent interest to C for cash. On August 13, 1989, P acquires A's entire 40-percent interest in exchange for P stock representing an insignificant percentage of the outstanding P voting stock in a "B" reorganization.

There is an ownership change immediately following the B reorganization, because the percentage of L stock held (through attribution, as described below) by P shareholders (all of whom are less than-5-percent shareholders who are treated as one 5-percent shareholder) and C (100 percent—P shareholders-85 percent; C-15 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by P shareholders and C at any time during the testing period (45 percent held constructively by P shareholders prior to August 13, 1989).

Example 13.—The stock of L corporation is widely held by the public; no single shareholder owns five percent or more of L stock. G corporation also is widely held with no shareholder owning five percent or more. On January 1, 1988, L corporation and G corporation merge (in a tax-free transaction), with L surviving, and G shareholders receive 49 percent of L stock. On July 1, 1988, B, an individual who has never owned stock in L or G, purchases five percent of L stock in a transaction on a public stock exchange.

The merger of L and G is not an ownership change of L, because the percentage of stock owned by the less-than-5-percent shareholders of G (who are aggregated and treated as a single 5-percent shareholder) (49 percent) has not increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders during the testing period (0 percent prior to the merger). The purchase of L stock by B is an owner shift involving a five-percent shareholder, which is presumed (unless otherwise established) to have been made proportionately from the groups of former G and L shareholders (49 percent from the G shareholders and 51 percent from the L shareholders). There is an ownership change of L because, immediately after the owner shift involving B, the percentage of stock owned by the G shareholders (presumed to be 46.55 percent—49 percent actually acquired in the merger less 2.45 percent presumed sold to B) and B (5 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by those shareholders at any time during the testing period (0 percent prior to the merger).

Example 14.—The stock of L corporation and G corporation is widely held by the public; neither corporation has any shareholder owning as much as five percent of its stock. On January 1, 1988, B purchases 10 percent of L stock. On July 1, 1988, L and G merge (in a tax-free transaction), with L surviving, and G shareholders receiving 49 percent of L stock.

The merger of L and G is an ownership change because, immediately after the merger, the percentage of stock owned by G shareholders (49 percent) and B (5.1 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the stock purchase by B).

Attribution and aggregation of stock ownership

Attribution from entities.—In determining whether an ownership change has occurred, the constructive ownership rules of section 318, with several modifications, are applied (new sec. 382(l)(3)). Except to the extent provided in regulations, the rules for attributing ownership of stock (within the meaning of new section 382(k)(6)) from corporations to their shareholders are applied without regard to the extent of the shareholders' ownership in the corporation.[30] Thus, any stock owned by a corporation is treated as being owned proportionately by its shareholders. Moreover, except as provided in regulations, any stock attributed to a corporation's shareholders is not treated as being held by such corporation. Stock attributed from a partnership, estate or trust similarly shall not be treated as being held by such entity. The effect of the attribution rules is to prevent application of the special limitations after an acquisition that does not result in a more than 50 percent change in the ultimate beneficial ownership of a loss corporation.[31] Conversely, the attribution rules result in an ownership change where more than 50 percent of a loss corporation's stock is acquired indirectly through an acquisition of stock in the corporation's parent corporation.

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[30] The attribution rules apply to stock or other interests in a manner consistent with the basic definition of an ownership change under the Act. Thus, section 318 is applied only to "stock" that is taken into account for purposes of section 382. For example, assume a corporation owns both common stock and stock described in section 1504(a)(4) of a type which is not counted in determining whether there has been an ownership change (referred to as "pure preferred") in a holding company. The pure preferred represents 55 percent of the holding company's value. The holding company's only asset consists of 100 percent of the common stock—the only class outstanding—in an operating subsidiary that is a loss corporation. The sale of the pure preferred would not constitute an ownership change because no stock in the loss corporation may be attributed through such stock. On the other hand, assume 100 percent of the stock in a loss corporation is transferred in a section 351 exchange, in which the loss corporation's sole shareholder receives pure preferred representing 51 percent of the transferee's value, and an unrelated party receives 100 percent of the transferee's common stock. Here, an ownership change would result with respect to the loss corporation.

Similar rules would apply where a loss corporation is owned directly or indirectly by a partnership (or other intermediary) that has outstanding ownership interests substantially similar to a pure preferred stock interest.

[31] The Act contemplates that regulations may provide rules to allow a widely held loss corporation to establish the extent, if any, to which there is overlapping stock ownership between an acquiring widely held corporation and such loss corporation.

Example 15.—L corporation is publicly traded; no shareholder owns as much as five percent. P corporation is publicly traded; no shareholder owns as much as five percent. On January 1, 1988, P corporation purchases 100 percent of L corporation stock on the open market. The L stock owned by P is attributed to the shareholders of P, all of whom are less-than-5-percent shareholders who are treated as a single, separate 5-percent shareholder under section 382(g)(4)(C). Accordingly, there has been an ownership change of L, because the percentage of stock owned by the P shareholders after the purchase (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by that group at any time during the testing period (0 percent prior to January 1, 1988).

Aggregation rules.—Special aggregation rules are applied for all stock ownership, actual or deemed, by shareholders of a corporation who are less-than-5-percent shareholders. Except as provided in regulations, stock owned by such persons is treated as being held by a single, separate 5-percent shareholder. For purposes of determining whether transactions following an equity structure shift or owner shift involving a 5-percent shareholder constitute an ownership change, the aggregation rules trace any subsequent change in ownership by a group of less-than-5-percent shareholders. In analyzing subsequent shifts in ownership, unless a different proportion is established otherwise, acquisitions of stock shall be treated as being made proportionately from all shareholders immediately before such acquisition.

Example 16.—Corporation A is widely held by a group of less-than-5-percent shareholders ("Shareholder Group A"). Corporation A owns 80 percent of both corporation B and corporation C, which respectively own 100 percent of corporation L and corporation P. Individual X owns the remaining stock in B (20 percent) and individual Y owns the remaining stock in C (20 percent). On January 1, 1988, L and P are, respectively, the only assets of B and C; and B and C are of equal value. On January 1, 1988, B merges into C with C surviving. After the merger, X owns 10 percent of C stock, Y owns 10 percent of C stock, and A owns 80 percent of C stock. The attribution rules (see sec. 382(1)(3)) and special aggregation rules (see sec. 382(g)(4)) apply to treat Shareholder Group A as a single, separate 5-percent shareholder owning 80 percent of the stock of L prior to the merger. Following the merger, Shareholder Group A still owns 80 percent of the stock of L, X owns 10 percent of the stock of L, and Y owns 10 percent of the stock of L. No ownership change occurs as a result of the merger, because the stock of L owned by Shareholder Group A is the same before and after the merger (80 percent), the stock of L owned by X has not increased but has decreased, and the stock of L owned by Y (0 percent before the merger and 10 percent after the merger) has not increased by more than 50 percentage points.

Example 17.—L corporation is publicly traded; no shareholder owns more than five percent. LS is a wholly owned subsidiary of L corporation. On January 1, 1988, L distributes all the stock of LS pro rata to the L shareholders. There has not been any change in the respective ownership of the stock of LS, because the less-than-5 percent shareholders of L, who are aggregated and treated as a single, separate 5-percent shareholder, are treated as owning 100 percent of LS (by attribution) before the distribution and directly own 100 percent of LS after the distribution. Thus, no owner shift involving a 5-percent shareholder has occurred; accordingly, there has not been an ownership change.

Example 18.—L Corporation is valued at $600. Individual A owns 30 percent of L stock, with its remaining ownership widely held by less-than-5-percent shareholders ("Shareholder Group L"). P corporation is widely held by less-than-5-percent shareholders ("Shareholder Group P"), and is valued at $400. On January 1, 1988, L and P consolidate in a tax free reorganization into L/P Corporation, with 60 percent of the value of such stock being distributed to former L corporation shareholders. On June 15, 1988, 17 percent of L/P corporation stock is acquired in a series of open market transactions by individual B. At all times between January 1, 1988 and June 15, 1988, A's ownership interest in L/P Corporation remained unchanged.

The consolidation by L and P on January 1, 1988 is an equity structure shift, but not an ownership change with respect to L. Under the attribution and aggregation rules, the ownership interest in new loss corporation, L/P Corporation, is as follows: A owns 18 percent (60 percent of 30 percent), Shareholder Group L owns 42 percent (60 percent of 70 percent) and Shareholder Group P owns 40 percent. The only 5-percent shareholder whose stock interest in new loss corporation increased relative to the lowest percentage of stock ownership in old loss corporation during the testing period, Shareholder Group P, did not increase by more than 50 percentage points.

The Act provides that, unless a different proportion is established by the taxpayer or the Internal Revenue Service, acquisitions of stock following the consolidation are treated as being made proportionately from all shareholders immediately before such transaction. Thus, under the general rule, B's open market purchase on June 15, 1988 of L/P Corporation stock would be treated as being made proportionately from A, Shareholder Group L, and Shareholder Group P. As a result, the application of this convention without modification would result in an ownership change, because the interests of B (17 percent) and Shareholder Group P (40 percent less the 6.8 percent deemed acquired by B) in new loss corporation would have increased by more than 50 percentage points during the testing period (50.2 percent). A's ownership interest in L/P corporation, however, has in fact remained unchanged. Because L/P Corporation could thus establish that the acquisition by B was not proportionate from all existing shareholders, however, it would be permitted to establish a different proportion for the deemed shareholder composition following B's purchase as follows: (1) A actually owns 18 percent, (2) B actually owns 17 percent, (3) Shareholder Group L is deemed to own 33.3 percent (42 percent less (17 percent x 42/82)), and (4) Shareholder Group P is deemed to own 31.7 percent (40 percent less (17 percent x 40/82)). If L/P Corporation properly establishes these facts, no ownership change has occurred, because B and Shareholder Group P have a stock interest in L/P Corporation (48.7 percent) that has not increased by more than 50 percentage points over the lowest percentage of stock owned by such shareholders in L/P Corporation, or L Corporation at any time during the testing period (0 percent).

If B purchased eleven percent from A, there would be an ownership change. The presumption does not apply in the case of subsequent purchases from persons who are 5-percent shareholders without regard to the aggregation rules.

Other attribution rules.—The family attribution rules of sections 318(a)(1) and 318(a)(5)(B) do not apply, but an individual, his spouse, his parents, his children, and his grandparents are treated as a single shareholder. "Back" attribution to partnerships, trusts, estates, and corporations from partners, beneficiaries, and shareholders will not apply except as provided in regulations.

The Act does not provide rules for attributing stock that is owned by a government. For example, stock that is owned by a foreign government is not treated as owned by any other person. Thus, if a government of a country owned 100% of the stock of a corporation and, within the testing period, sold all of such stock to members of the public who were citizens of the country, an ownership change would result. Governmental units, agencies, and instrumentalities that derive their powers, rights, and duties from the same sovereign authority will be treated as a single shareholder.

Finally, except as provided in regulations, the holder of an option is treated as owning the underlying stock if such a presumption would result in an ownership change.[32] This rule is intended to apply to options relating to stock in a loss corporation as well as any other instrument relating to the direct or indirect ownership in a loss corporation. The subsequent exercise of an option is disregarded if the holder of the option has been treated as owning the underlying stock. On the other hand, if the holder of the option was not treated as owning the underlying stock, the subsequent exercise will be taken into account in determining whether there is an owner shift at time of exercise. This rule is to be applied on an option-by-option basis so that, in appropriate cases, certain options will be deemed exercised while others may not. Similarly, a person will be treated as owning stock that may be acquired pursuant to any contingency, warrant, right to acquire stock, conversion feature, put, or similar interest, if such a presumption results in an ownership change.[33] If the option or other contingency expires

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[32] Thus, except as provided in regulations, the stock underlying an option or other interest subject to the rule in section 382(l)(3)(A)(iv) may be taken into account on and after the date on which the interest is acquired or is later transferred, for purposes of determining whether an ownership change occurs following any transaction (including such acquisition or transfer). It is expected that the Treasury Department may consider whether there are circumstances in which it may be appropriate to limit the operation of this rule to transactions occuring during any three-year testing period that includes the date the option or other interest is issued or transferred.

[33] The types of rights to acquire stock that are subject to this rule thus may extend beyond those rights that have been treated as options under section 318(a)(4) as applied for other purposes. For example, it is intended that a right to acquire unissued stock of a corporation would (except as provided in regulations) be treated as exercised if an ownership change would result,

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without a transfer of stock ownership, but the existence of the option or other contingency resulted in an ownership change under this rule, the loss corporation will be able to file amended tax returns (subject to any applicable statute of limitations) for prior years as if the corporation had not been subject to the special limitations.

Example 19.—L corporation has 1,000 shares of stock outstanding, which are owned by 25 unrelated shareholders, none of whom own five percent or more. P corporation is wholly owned by individual A. On January 1, 1987, L corporation acquires 100 percent of P stock from A. In exchange, A receives 750 shares of L stock and a contingent right to receive up to an additional 500 shares of L stock, depending on the earnings of P corporation over the next five years.

Except as provided in regulations, A would be treated as owning all the L stock that he might receive on occurrence of the contingency (and such stock is thus treated as additional outstanding stock). Accordingly, an ownership change of L would occur, because the percentage of stock owned (and treated as owned) by A (1,250 shares—55.5 percent (33.3 percent (750 of 2,250 shares) directly and 22.2 percent (500 of 2,250 shares) by attribution)) increased by more than 50 percentage points over the lowest percentage of stock owned by A at any time during the testing period (0 percent prior to January 1, 1987).

Example 20.—L corporation and P corporation are publicly traded; no shareholder owns five percent or more of either corporation. On January 1, 1989, P corporation purchases 40 percent of the stock in L corporation and an option to acquire the remaining 60 percent of L corporation stock. The option is exercisable three years after the date on which the option is issued.

Under the Act, if P is treated as owning the L corporation stock obtainable on exercise of the option, then P corporation would be treated as owning 100 percent of L corporation. Thus, the presumption provided by section 382(l)(3)(A) would apply, and an ownership change would result. The same result would apply even if the option were exercisable only in the event of a contingency such as the attaining of a specified earnings level by the end of a specified period.

Stock acquired by reason of death, gift, divorce or separation.—If (i) the basis of any stock in the hands of any person is determined under section 1014 (relating to property acquired from a decedent), section 1015 (relating to property acquired by a gift or transfer in trust), or section 1041(b) (relating to transfers of property between spouses or incident to divorce), (ii) stock is received by any person in satisfaction of a right to receive a pecuniary bequest, or (iii) stock is acquired by a person pursuant to any divorce or separation instrument (within the meaning of section 71(b)(2)), then such persons shall be treated as owning such stock during the period such

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without regard to how such a right may have been treated under section 318(a)(4). *Compare* Rev. Rul. 68-601, 1968-2 C.B. 124; *J. Milton Sorem* v. *Commissioner*, 335 F.2d 275 (10th Cir. 1964); *W.H. Bloch* v. *United States*, 261 F. Supp. 597 (S.D. Tex. 1967), *aff'd per curiam*, 386 F.2d 531 (5th Cir., 1968). It is expected that Treasury will exercise its regulatory authority, however, to prevent the use of this rule in appropriate cases—as one example, where options or other interests subject to the rule are issued shortly after a corporation has incurred a de minimis amount of loss.

stock was owned by the person from whom it was acquired (new sec. 382(l)(3)(B)). Such transfers, therefore, would not constitute owner shifts.

Special rule for employee stock ownership plans.—If certain ownership and allocation requirements are satisfied, the acquisition of employer securities (within the meaning of section 409(l)) by either a tax credit employee stock ownership plan or an employee stock ownership plan (within the meaning of section 4975(e)(7)) shall not be taken into account in determining whether an ownership change has occurred (new sec. 382(l)(3)(C)). The acquisition of employer securities from any such plan by a participant of any such plan pursuant to the requirements of section 409(h) also will not be taken into account in determining whether an ownership change has occurred.

Utilization of holding company structures.—The mere formation of a holding company unaccompanied by a change in the beneficial ownership of the loss corporation will not result in an ownership change. The attribution rules of section 318, as modified for purposes of applying these special limitations, achieve this result by generally disregarding any corporate owner of stock as the owner of any loss corporation stock (new sec. 382(l)(3)(A)(ii)(II)). Instead, the attribution rules are designed to provide a mechanism for tracking the changes in ownership by the ultimate beneficial owners of the loss corporation. The creation of a holding company structure is significant to the determination of whether an ownership change has occurred only if it is accompanied by a change in the ultimate beneficial ownership of the loss corporation.

Example 21.—The stock of L corporation is owned equally by unrelated individuals, A, B, C, and D. On January 1, 1988, A, B, C, and D contribute their L corporation stock to a newly formed holding company ("HC") in exchange for equal interests in stock and securities of HC in a transaction that qualifies under section 351.

The formation of HC does not result in an ownership change with respect to L. Under the attribution rules, A, B, C, and D following the incorporation of L corporation are considered to own 25 percent of the stock of L corporation and, unless provided otherwise in regulations, HC is treated as not holding any stock in L corporation. Accordingly, the respective holdings in L corporation were not altered to any extent and there is thus no owner shift involving a 5-percent shareholder. The result would be the same if L corporation were owned by less-than-5-percent shareholders prior to the formation of the holding company.

Example 22.—The stock of L corporation is widely held by the public ("Public/L") and is valued at $600. P is also widely held by the public ("Public/P") and is valued at $400. On January 1, 1988, P forms Newco with a contribution of P stock. Immediately thereafter, Newco acquires all of the properties of L corporation in exchange for its P stock in a forward triangular merger qualifying under section 368(a)(2)(D). Following the transaction, Public/L and Public/P respectively are deemed to own 60 percent and 40 percent of P stock.

Inserting P between Public/L and L corporation (which becomes Newco in the merger) does not result in an ownership change with respect to Newco, the new loss corporation. Under new section

382(g)(4)(B)(i), Public/L and Public/P are each treated as a separate 5-percent shareholder of Newco, the new loss corporation.[34] Unless regulations provide otherwise, P's direct ownership interest in L corporation is disregarded. Because the percentage of Newco stock owned by Public/P shareholders after the equity structure shift (40 percent) has not increased by more than 50 percentage points over the lowest percentage of stock of L (the old loss corporation) owned by such shareholders at any time during the testing period (0 percent prior to January 1, 1988), the transaction does not constitute an ownership change with respect to Newco.

3-year testing period

In general, the relevant testing period for determining whether an ownership change has occurred is the three-year period preceding any owner shift involving a 5-percent shareholder or any equity structure shift (new sec. 382(i)(1)). Thus, a series of unrelated transactions occurring during a three-year period may constitute an ownership change. A shorter period, however, may be applicable following any ownership change. In such a case, the testing period for determining whether a second ownership change has occurred does not begin before the day following the first ownership change (new sec. 382(i)(2)).

In addition, the testing period does not begin before the first day of the first taxable year from which there is a loss carryforward (including a current NOL that is defined as a pre-change loss) or excess credit (new sec. 382(i)(3)). Thus, transactions that occur prior to the creation of any attribute subject to limitation under section 382 or section 383 are disregarded. Except as provided in regulations, the special rule described above does not apply to any corporation with a net unrealized built-in loss. The Act contemplates, however, that the regulations will permit such corporations to disregard transactions that occur before the year for which such a corporation establishes that a net unrealized built-in loss first arose.

Effect of ownership change

Section 382 limitation

For any taxable year ending after the change date (*i.e.*, the date on which an owner shift resulting in an ownership change occurs or the date of the reorganization in the case of an equity structure shift resulting in an ownership change), the amount of a loss corporation's (or a successor corporation's) taxable income that can be offset by a pre-change loss (described below) cannot exceed the section 382 limitation for such year (new sec. 382(a)). The section 382 limitation for any taxable year is generally the amount equal to the value of the loss corporation immediately before the ownership change multiplied by the long-term tax-exempt rate (described below) (new sec. 382(b)(1)).

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[34] The rules described above aggregate all less-than-5-percent shareholders of any corporation. These aggregation rules are to be applied after taking into account the attribution rules. In the above example, the old loss corporation and new loss corporation are properly treated as the same corporation. Thus, even though L does not survive the reorganization, Public/L is properly treated as a continuing 5-percent shareholder of Newco, the new loss corporation. The same result would be appropriate if the transaction had been structured as a reverse triangular merger under section 368(a)(2)(E).

The Treasury Department is required to prescribe regulations regarding the application of the section 382 limitation in the case of a short taxable year. These regulations will generally provide that the section 382 limitation applicable in a short taxable year will be determined by multiplying the full section 382 limitation by the ratio of the number of days in the year to 365. Thus, taxable income realized by a new loss corporation during a short taxable year may be offset by pre-change losses not exceeding a ratable portion of the full section 382 limitation.

If there is a net unrealized built-in gain, the section 382 limitation for any taxable year is increased by the amount of any recognized built-in gains (determined under rules described below). Also, the section 382 limitation is increased by built-in gain recognized by virtue of a section 338 election (to the extent such gain is not otherwise taken into account as a built-in gain). Finally, if the section 382 limitation for a taxable year exceeds the taxable income for the year, the section 382 limitation for the next taxable year is increased by such excess.

If two or more loss corporations are merged or otherwise reorganized into a single entity, separate section 382 limitations are determined and applied to each loss corporation that experiences an ownership change.

Example 23.—X corporation is wholly owned by individual A and its stock has a value of $3,000; X has NOL carryforwards of $10,000. Y corporation is wholly owned by individual B and its stock has a value of $9,000; Y has NOL carryforwards of $100. Z corporation is owned by individual C and its stock has a value of $18,000; Z has no NOL carryforwards. On July 22, 1988, X, Y and Z consolidate into W corporation in a transaction that qualifies as a tax-free reorganization under section 368(a)(1)(A). The applicable long-term tax-exempt rate on such date is 10 percent. As a result of the consolidation, A receives 10 percent of W stock, B receives 30 percent and C receives 60 percent.

The consolidation of X, Y and Z results in an ownership change for old loss corporations X and Y. The Act applies a separate section 382 limitation to the utilization of the NOL carryforwards of each loss corporation that experiences an ownership change. Therefore, the annual limitation on X's NOL carryforwards is $300 and the annual limitation Y's NOL carryforwards is $900.

For W's taxable year ending on December 31, 1989, W's taxable income before any reduction for its NOLs is $1,400. The amount of taxable income of W that may be offset by X and Y's pre-change losses (without regard to any unused section 382 limitation) is $400 (the $300 section 382 limitation for X's NOL carryforwards and all $100 of Y's NOL carryforwards because that amount is less than Y's $900 section 382 limitation). The unused portion of Y's section 382 limitation may not be used to augment X's section 382 limitation for 1989 or in any subsequent year.

Special rule for post-change year that includes the change date.—In general, the section 382 limitation with respect to an ownership change that occurs during a taxable year does not apply to the utilization of losses against the portion of the loss corporation's taxable income, if any, allocable to the period before the change. For this purpose, except as provided in regulations, taxable income (not including built-in gains or losses, if there is a net unrealized built-in gain or loss) realized during the change year is allocated ratably to each day in the year. The regulations may provide that income realized before the change date from discrete sales of assets would be excluded from the ratable allocation and could be offset without limit by pre-change losses. Moreover, these regulations may provide a loss corporation with an option to determine the taxable income allocable to the period before the change by closing its books on the change date and thus forgoing the ratable allocation.

Value of loss corporation

The value of a loss corporation is generally the fair market value of the corporation's stock (including preferred stock described in section 1504(a)(4)) immediately before the ownership change (new sec. 382(e)(1)). If a redemption occurs in connection with an ownership change—either before or after the change—the value of the loss corporation is determined after taking the redemption into account (new sec. 382(e)(2)).[35] The Treasury Department is given regulatory authority to treat other corporate contractions in the same manner as redemptions for purposes of determining the loss corporation's value. The Treasury Department also is required to prescribe such regulations as are necessary to treat warrants, options, contracts to acquire stock, convertible debt, and similar interests as stock for purposes of determining the value of the loss corporation (new sec. 382(k)(6)(B)(i)).

In determining value, the price at which loss corporation stock changes hands in an arms-length transaction would be evidence, but not conclusive evidence, of the value of the stock. Assume, for example, that an acquiring corporation purchased 40 percent of loss corporation stock over a 12-month period. Six months following this 40 percent acquisition, the acquiring corporation purchased an additional 20 percent of loss corporation stock at a price that reflected a premium over the stock's proportionate amount of the value of all the loss corporation stock; the premium is paid because the 20-percent block carries with it effective control of the loss corporation. Based on these facts, it would be inappropriate to simply gross-up the amount paid for the 20-percent interest to determine the value of the corporation's stock. Under regulations, it is anticipated that the Treasury Department will permit the loss corporation to be valued based upon a formula that grosses up the purchase price of all of the acquired loss corporation stock if a control block of such stock is acquired within a 12-month period.

Example 24.—All of the outstanding stock of L corporation is owned by individual A and has a value of $1,000. On June 15, 1988, A sells 51 percent of his stock in L to unrelated individual B. On

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[35] It was intended that the redemption provisions would apply to transactions that effectively accomplish similar economic results, without regard to formal differences in the structure used, or the order of events by which similar consequences are achieved. Thus, the fact that a transaction might not constitute a "redemption" for other tax purposes does not determine the treatment of the transaction for purposes of this provision. As one example, a "bootstrap" acquisition, in which aggregate corporate value is directly or indirectly reduced or burdened by debt to provide funds to the old shareholders, could generally be subject to the provision. This may include cases in which debt used to pay the old shareholders remains an obligation of an acquisition corporation or an affiliate, where the source of funds for repayment of the obligation is the acquired corporation. See section 382(m)(4), relating to corporate contractions.

January 1, 1989, L and A enter into a 15-year management contract and L redeems A's remaining stock interest in such corporation. The latter transactions were contemplated in connection with B's earlier acquisition of stock in 1988.

The acquisition of 51 percent of the stock of L on June 15, 1988, constituted an ownership change. The value of L for purposes of computing the section 382 limitation is the value of the stock of such corporation immediately before the ownership change. Although the value of such stock was $1,000 at that time, the value must be reduced by the value of A's stock that was subsequently redeemed in connection with the ownership change.

Long-term tax-exempt rate

The long-term tax-exempt rate is defined as the highest of the Federal long-term rates determined under section 1274(d), as adjusted to reflect differences between rates on long-term taxable and tax-exempt obligations, in effect for the month in which the change date occurs or the two prior months (new sec. 382(f)). The Treasury Department will publish the long-term tax-exempt rate by revenue ruling within 30 days after the date of enactment and monthly thereafter. The long-term tax-exempt rate will be computed as the yield on a diversified pool of prime, general obligation tax-exempt bonds with remaining periods to maturity of more than nine years.

The use of a rate lower than the long-term Federal rate is necessary to ensure that the value of NOL carryforwards to the buying corporation is not more than their value to the loss corporation. Otherwise there would be a tax incentive to acquire loss corporations. If the loss corporation were to sell its assets and invest in long-term Treasury obligations, it could absorb its NOL carryforwards at a rate equal to the yield on long-term government obligations. Since the price paid by the buyer is larger than the value of the loss company's assets (because the value of NOL carryforwards are taken into account), applying the long-term Treasury rate to the purchase price would result in faster utilization of NOL carryforwards by the buying corporation. The long-term tax-exempt rate normally will fall between 66 (1 minus the maximum corporate tax rate of 34 percent) and 100 percent of the long-term Federal rate.

Example 25.—Corporation L has $1 million of net operating loss carryforwards. L's taxable year is the calendar year, and on July 1, 1987, all of the stock of L is sold in a transaction constituting an ownership change of L. (Assume the transaction does not terminate L's taxable year.) On that date, the value of L's stock was $500,000 and the long-term tax-exempt rate was 10 percent. Finally, L incurred net operating loss during 1987 of $100,000, and L had no built-in gains or losses.

On these facts, the taxable income of L after July 1, 1987, that could be offset by L's losses incurred prior to July 1, 1987, would generally be limited. In particular, for all taxable years after 1987, the pre-change losses of L generally could be used to offset no more than $50,000 of L's taxable income each year. (For L's 1987 taxable year, the limit would be $25,000 (1/2 x the $50,000 section 382 limitation)). The pre-change losses of L would constitute the $1 million of NOL carryforwards plus one-half of the 1987 net operating loss, or a total of $1,050,000. If, in taxable year 1988, L had $30,000 of taxable income to be offset by L's losses, it could be fully offset by L's pre-change NOLs and the amount of L's 1989 taxable income that could be offset by pre-change losses would be limited to $95,000 ($50,000 annual limit plus $45,000 carryover).

If L had income of $100,000 in 1987, instead of a net operating loss, L's 1987 taxable income that could be offset by pre-change losses would generally be limited to $75,000 (1/2 x the $50,000 section 382 limitation plus 1/2 x $100,000 1987 income). (In appropriate circumstances, the Secretary could, by regulations, require allocation of income using a method other than daily proration. Such circumstances might include, for example, an instance in which substantial income-producing assets are contributed to capital after the change date.)

Continuity of business enterprise requirements

Following an ownership change, a loss corporation's NOL carryforwards (including any recognized built-in losses, described below) are subject to complete disallowance (except to the extent of any recognized built-in gains or section 338 gain, described below), unless the loss corporation's business enterprise is continued at all times during the two-year period following the ownership change. If a loss corporation fails to satisfy the continuity of business enterprise requirements, no NOL carryforwards would be allowed to the new loss corporation for any post-change year. This continuity of business enterprise requirement is the same requirement that must be satisfied to qualify a transaction as a tax-free reorganization under section 368. (*See* Treasury regulation section 1.368-1(d)). Under these continuity of business enterprise requirements, a loss corporation (or a successor corporation) must either continue the old loss corporation's historic business or use a significant portion of the old loss corporation's assets in a business. Thus, the requirements may be satisfied even though the old loss corporation discontinues more than a minor portion of its historic business. Changes in the location of a loss corporation's business or the loss corporation's key employees, in contrast to the results under the business-continuation rule in the 1954 Code version of section 382(a), will not constitute a failure to satisfy the continuity of business enterprise requirements under the conference agreement.

Reduction in loss corporation's value for certain capital contributions

Any capital contribution (including a section 351 transfer) that is made to a loss corporation as part of a plan a principal purpose of which is to avoid any of the special limitations under section 382 shall not be taken into account for any purpose under section 382. For purposes of this rule, except as provided in regulations, a capital contribution made during the two-year period ending on the change date is irrebuttably presumed to be part of a plan to avoid the limitations. The application of this rule will result in a reduction of a loss corporation's value for purposes of determining the section 382 limitation. The term "capital contribution" is to be interpreted broadly to encompass any direct or indirect infusion of capital into a loss corporation (*e.g.*, the merger of one corporation into a commonly owned loss corporation). Regulations generally will except (i) capital contributions received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss) where an ownership change occurs within two years of incorporation, (ii) capital contributions received before the first year from which there is an NOL or excess credit carryforward (or in which a net unrealized built-in loss arose), and (iii) capital contributions made to continue basic operations of the corporation's business (*e.g.* to meet the monthly payroll or fund other operating expenses of the loss corporation). The regulations also may take into account, under appropriate circumstances, the existence of substantial nonbusiness assets on the change date (as described below) and distributions made to shareholders subsequent to capital contributions, as offsets to such contributions.

Reduction in value for corporations having substantial nonbusiness assets

If at least one-third of the fair market value of a corporation's assets consists of nonbusiness assets, the value of the loss corporation, for purposes of determining the section 382 limitation, is reduced by the excess of the value of the nonbusiness assets over the portion of the corporation's indebtedness attributable to such assets. The term nonbusiness assets includes any asset held for investment, including cash and marketable stock or securities. Assets held as an integral part of the conduct of a trade or business (*e.g.*, assets funding reserves of an insurance company or similar assets of a bank) would not be considered nonbusiness assets. In addition, stock or securities in a corporation that is at least 50 percent owned (voting power and value) by a loss corporation are not treated as nonbusiness assets. Instead, the parent loss corporation is deemed to own its ratable share of the subsidiary's assets. The portion of a corporation's indebtedness attributable to nonbusiness assets is determined on the basis of the ratio of the value of nonbusiness assets to the value of all the loss corporation's assets.

Regulated investment companies, real estate investment trusts, and real estate mortgage investment conduits are not treated as having substantial nonbusiness assets.

Losses subject to limitation

The term "pre-change loss" includes (i) for the taxable year in which an ownership change occurs, the portion of the loss corporation's NOL that is allocable (determined on a daily pro rata basis, without regard to recognized built-in gains or losses, as described below) to the period in such year before the change date, (ii) NOL carryforwards that arose in a taxable year preceding the taxable year of the ownership change and (iii) certain recognized built-in losses and deductions (described below).

For any taxable year in which a corporation has income that, under section 172, may be offset by both a pre-change loss (*i.e.*, an NOL subject to limitation) and an NOL that is not subject to limitation, taxable income is treated as having been first offset by the pre-change loss (new sec. 382(l)(2)(B)). This rule minimizes the NOLs that are subject to the special limitations. For purposes of determining the amount of a pre-change loss that may be carried to a taxable year (under section 172(b)), taxable income for a taxable year is treated as not greater than the section 382 limitation for such year reduced by the unused pre-change losses for prior taxable years. (New sec. 382(l)(2)(A)).

Built-in losses

If a loss corporation has a net unrealized built-in loss, the recognized built-in loss for any taxable year ending within the five-year period ending at the close of the fifth post-change year (the "recognition period") is treated as a pre-change loss (new sec. 382(h)(1)(B)).

Net unrealized built-in losses.—The term "net unrealized built-in loss" is defined as the amount by which the fair market value of the loss corporation's assets immediately before the ownership change is less than the aggregate adjusted bases of a corporation's assets at that time. Under a *de minimis* exception, the special rule for built-in losses is not applied if the amount of a net unrealized built-in loss does not exceed 25 percent of the value of the corporation's assets immediately before the ownership change. For purposes of the *de minimis* exception, the value of a corporation's assets is determined by excluding any (1) cash, (2) cash items (as determined for purposes of section 368(a)(2)(F)(iv)), or (3) marketable securities that have a value that does not substantially differ from adjusted basis.

Example 26.—L corporation owns two assets: asset X, with a basis of $150 and a value of $50 (a built-in loss asset), and asset Y, with a basis of zero and a value of $50 (a built-in gain asset, described below). L has a net unrealized built-in loss of $50 (the excess of the aggregate bases of $150 over the aggregate value of $100).

Recognized built-in losses.—The term "recognized built-in loss" is defined as any loss that is recognized on the disposition of an asset during the recognition period, except to the extent that the new loss corporation establishes that (1) the asset was not held by the loss corporation immediately before the change date, or (2) the loss (or a portion of such loss) is greater than the excess of the adjusted basis of the asset on the change date over the asset's fair market value on that date. The recognized built-in loss for a taxable year cannot exceed the net unrealized built-in loss reduced by recognized built-in losses for prior taxable years ending in the recognition period.

The amount of any recognized built-in loss that exceeds the section 382 limitation for any post-change year must be carried forward (not carried back) under rules similar to the rules applicable to net operating loss carryforwards and will be subject to the special limitations in the same manner as a pre-change loss.

Accrued deductions.—The Treasury Department is authorized to issue regulations under which amounts that accrue before the change date, but are allowable as a deduction on or after such date (*e.g.*, deductions deferred by section 267 or section 465), will be treated as built-in losses. Depreciation deductions cannot be treated as accrued deductions or built-in losses;[36] however, the Secretary of the Treasury is required to conduct a study of whether built-in depreciation deductions should be subject to section 382, and report to the tax-writing committees of the Congress before January 1, 1989.

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[36] Similarly, Section 382 does not provide relief for built-in income other than gain on disposition of an asset.

Built-in gains

If a loss corporation has a net unrealized built-in gain, the section 382 limitation for any taxable year ending within the five-year recognition period is increased by the recognized built-in gain for the taxable year (new sec. 382(h)(1)(A)).

Net unrealized built-in gains.—The term "net unrealized built-in gain" is defined as the amount by which the value of a corporation's assets exceeds the aggregate bases of such assets immediately before the ownership change. Under the *de minimis* exception described above, the special rule for built-in gains is not applied if the amount of a net unrealized built-in gain does not exceed 25 percent of the value of a loss corporation's assets.

Recognized built-in gains.—The term "recognized built-in gain" is defined as any gain recognized on the disposition of an asset during the recognition period, if the taxpayer establishes that the asset was held by the loss corporation immediately before the change date, to the extent the gain does not exceed the excess of the fair market value of such asset on the change date over the adjusted basis of the asset on that date. The recognized built-in gain for a taxable year cannot exceed the net unrealized built-in gain reduced by the recognized built-in gains for prior years in the recognition period.

Bankruptcy proceedings

The special limitations do not apply after any ownership change of a loss corporation if (1) such corporation was under the jurisdiction of a bankruptcy court in a Title 11 or similar case immediately before the ownership change, and (2) the corporation's historic shareholders and creditors (determined immediately before the ownership change) own 50 percent of the value and voting power of the loss corporation's stock immediately after the ownership change (new sec. 382(l)(5)). The 50-percent test is satisfied if the corporation's shareholders and creditors own stock of a controlling corporation that is also in bankruptcy (new sec. 382(l)(5)(A)(ii).

This special rule applies only if the stock-for-debt exchange, reorganization, or other transaction is ordered by the court or is pursuant to a plan approved by the court. For purposes of the 50-percent test, stock of a creditor that was converted from indebtedness is taken into account only if such indebtedness was held by the creditor for at least 18 months before the date the bankruptcy case was filed or arose in the ordinary course of the loss corporation's trade or business and is held by the person who has at all times held the beneficial interest in the claim. Indebtedness will be considered as having arisen in the ordinary course of the loss corporation's business only if the indebtedness was incurred by the loss corporation in connection with the normal, usual, or customary conduct of its business. It is not relevant for this purpose whether the debt was related to ordinary or capital expenditures of the loss corporation. In addition, stock of a shareholder is taken into account only to the extent such stock was received in exchange for stock that was held immediately before the ownership change.

If the exception for bankruptcy proceedings applies, several special rules are applicable. First, the pre-change losses and excess credits that may be carried to a post-change year are reduced by one-half of the amount of any cancellation of indebtedness income that would have been included in the loss corporation's income as a result of any stock-for-debt exchanges that occur as part of the Title 11 or similar proceeding under the principles of section 108(e)(10) (without applying section 108(e)(10)(B)). Thus, the NOL carryforwards would be reduced by 50 percent of the excess of the amount of the indebtedness canceled over the fair market value of the stock exchanged. Second, the loss corporation's pre-change NOL carryforwards are reduced by the interest on the indebtedness that was converted to stock in the bankruptcy proceeding and paid or accrued during the period beginning on the first day of the third taxable year preceding the taxable year in which the ownership change occurs and ending on the change date. Finally, after an ownership change that qualifies for the bankruptcy exception, a second ownership change during the following two-year period will result in the elimination of NOL carryforwards that arose before the first ownership change. The special bankruptcy provisions do not apply to stock-for-debt exchanges in informal workouts, but the Secretary of the Treasury is required to study informal bankruptcy workouts under sections 108 and 382, and report to the tax-writing committees of the Congress before January 1, 1988.

The Act provides an election, subject to such terms and conditions as the Secretary may prescribe, to forgo the exception for title 11 or similar cases (new sec. 382(l)(5)(H)). If this election is made, the general rules described above will apply except that the value of the loss corporation will reflect any increase in value resulting from any surrender or cancellation of creditors' claims in the transaction (for purposes of applying new section 382(e)).

Thrift institutions

A modified version of the bankruptcy exception (described above) applies to certain ownership changes of a thrift institution involved in a G reorganization by virtue of section 368(a)(3)(D)(ii). This rule also applies to ownership changes resulting from an issuance of stock or equity structure shift that is an integral part of a transaction involving such a reorganization, provided that the transaction would not have resulted in limitations under prior law.[37] The bankruptcy exception is applied to qualified thrift reorganizations by requiring shareholders and creditors (including depositors) to retain a 20-percent (rather than 50-percent) interest. For this purpose, the fair market value of the outstanding stock of the new loss corporation includes the amount of deposits in such corporation immediately after the change, as under prior law.[38] The general bankruptcy rules that eliminate from the NOL carryforwards both interest deductions on debt that was converted and income that would be recognized under the principles of section 108(e)(10) are not applicable to thrifts.

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[37] For example, a supervisory conversion of a mutual thrift into a stock thrift qualifying under section 368(a)(3)(D)(ii), followed by an issuance of stock for cash, would come within this special rule. The issuance of stock would not be regarded as a second ownership change for purposes of the bankruptcy exception.

Transactions involving solvent thrifts, including a purchase of the stock of a thrift, or merger of a thrift into another corporation, will be subject to the general rules relating to ownership changes. The conversion of a solvent mutual savings and loan association into a stock savings and loan (or other transactions involving a savings and loan not entitled to special treatment), although not within the special rules applicable to troubled thrifts, will not necessarily constitute an ownership change. In such a conversion, the mutual thrift converts to stock form as a preliminary step to the issuance of stock to investors for purposes of raising capital. Under prior law IRS rulings, the entire transaction may qualify as a tax-free reorganization if certain conditions are met. For purposes of determining whether there has been an ownership change causing a limitation on the use of losses, the issuance of stock generally will be treated under the rules applicable to owner shifts. For example, the depositors holding liquidation accounts would generally be considered a group of less-than-5-percent shareholders, and if the stock were issued entirely to less-than-5-percent shareholders, or 5-percent shareholders acquired less than 50 percent, no ownership change would occur. Treasury regulations may be issued, on a prospective basis, that would treat public offerings generally in the same manner as equity structure shifts and treat the old shareholders and the persons acquiring stock in the offering as separate 5-percent shareholder groups. If such regulations are issued and apply this same approach to the conversion of a solvent mutual savings and loan association to stock form and the issuance of new stock, an ownership change could result, however, if the value of the stock issued in the public offering exceeds the equity of the depositors in the mutual represented by liquidation accounts. The application of any such regulations to thrift institutions (whether solvent or insolvent) would not be effective before January 1, 1989.

Carryforwards other than NOLs

The Act also amends section 383, relating to special limitations on unused business credits and research credits, excess foreign tax credits, and capital loss carryforwards. Under regulations to be prescribed by the Secretary, capital loss carryforwards will be limited to an amount determined on the basis of the tax liability that is attributable to so much of the taxable income as does not exceed the section 382 limitation for the taxable year, with the same ordering rules that apply under present law. Thus, any capital loss carryforward used in a post-change year will reduce the section 382 limitation that is applied to pre-change losses. In addition, the amount of any excess credit that may be used following an ownership change will be limited, under regulations, on the basis of the tax liability attributable to an amount of taxable income that does not exceed the applicable section 382 limitation, after any NOL carryforwards, capital loss carryforwards, or foreign tax credits are taken into account. The Act also expands the scope of section 383 to include passive activity losses and credits and minimum tax credits.

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[38] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in H. Con Res. 395 as passed by the House and Senate in the 99th Congress. Also, under a literal interpretation of the statute, in order to meet the requirements of section 1504(a)(2), the shareholders and creditors of the old loss corporation must meet the 20-percent test in terms of value and voting power. New section 382(l)(5)(F)(ii)(III) provides a rule for determining the deemed value, but there is no similar rule for measuring voting power. It was not intended that the voting power requirement would apply in this situation to cause a failure of the 20 percent test solely because deposits do not carry adequate voting power. A technical correction may be needed so that the statute reflects this intent.

Anti-abuse rules

The Act does not alter the continuing application of section 269, relating to acquisitions made to evade or avoid taxes, as under prior law. Similarly, the SRLY and CRCO principles under the regulations governing the filing of consolidated returns will continue to apply. The *Libson Shops* doctrine will have no application to transactions subject to the provisions of the Act.

The Act provides that the Treasury Department shall prescribe regulations preventing the avoidance of the purposes of section 382 through the use of, among other things, pass-through entities. For example, a special allocation of income to a loss partner should not be permitted to result in a greater utilization of losses than would occur if the principles of section 382 were applicable.

In the case of partnerships, for example, the regulations are expected to limit the tax benefits that may be derived from transactions in which allocations of partnership income are made to a loss partner or to a corporation that is a member of a consolidated group with NOL carryovers (a "loss corporation partner") under an arrangement that contemplates the diversion of any more than an insignificant portion of the economic benefit corresponding to such allocation (or any portion of the economic benefit of the loss corporation partner's NOL) to a higher tax bracket partner.

This grant of authority contemplates any rules that the Treasury Department considers appropriate to achieve this objective. For example, regulations may provide, as a general rule, that the limitations of section 382 (and section 383) should be made applicable to restrict a loss corporation partner's use of losses against its distributive share of each item of partnership income and that any portion of the distributive share of partnership income so allocated which may not be offset by the loss corporation's NOLs should be taxed at the highest marginal tax rate. Such regulations could also provide that the allocation of income to the loss corporation may, in the discretion of the Secretary, be reallocated to the extent that other partners in the partnership have not been reasonably compensated for their services to the partnership. If the Treasury Department uses such a format to restrict the utilization of NOLs, it may be appropriate to exempt from these rules any partnership with respect to which, throughout the term of the partnership, (i) every allocation to every partner would be a qualified allocation as described in section 168(j)(9)(B) if it were made to a tax-exempt entity, with appropriate exceptions (e.g., section 704(c) allocations) and (ii) distributions are made to one partner only if there is a simultaneous pro rata distribution to all partners at the same time.

Special rules would, of course, have to be provided to apply section 382 (and section 383) in this context.

No inference was intended regarding whether allocations made to loss corporations by partnerships that involve transfers of the economic benefit of a loss partner's loss to another partner have substantial economic effect. As described in the report of the Committee on Finance, there are circumstances in which it appears to be questionable whether the economic benefit that corresponds to a special allocation to the NOL partner is fully received by such partner; however, some taxpayers nevertheless take the position that such allocations have substantial economic effect under section 704(b). The Treasury Department is expected to review this situation.

The regulations issued under this grant of authority with respect to partnerships should be effective for transactions after the date of enactment. Any regulations addressing other situations, under the Treasury Department's general authority to limit the ability of other parties to obtain any portion of the benefit of a loss corporation's losses, may be prospective within the general discretion of the Secretary.

1976 Act amendments

The Act generally repeals the amendments to section 382 and 383 made by the Tax Reform Act of 1976, effective retroactively as of January 1, 1986. Thus, the law that was in effect as of December 31, 1985, applies to transactions that are not subject to the new provisions because of the effective dates of the conference agreement. The Act, by repealing the 1976 Act amendments, also retroactively repeals section 108(e)(10)(C), as included by the Tax Reform Act of 1984.

Effective Dates

The provisions of the Act generally apply to ownership changes that occur on or after January 1, 1987. In the case of equity structure shifts (notwithstanding the fact that the transaction falls within the definition of an owner shift), the new rules apply to reorganizations pursuant to plans adopted on or after January 1, 1987. In the case of an ownership change occurring immediately after an owner shift (other than an equity structure shift) completed on or after January 1, 1987, new section 382 shall apply. In the case of an equity structure shift (including equity structure shifts that are also owner shifts), Congress intended that new section 382 shall apply to any post-1986 ownership change occurring immediately after the completion of any reorganization pursuant to a plan adopted on or after January 1, 1987. Congress also intended that new section 382 shall apply to any post-1986 ownership change occurring immediately after the completion of a reorganization pursuant to a plan adopted before January 1, 1987, unless the shift in ownership caused by such reorganization, when considered together only with any other shifts in ownership that may have occurred on or after May 6, 1986, and before December 31, 1986, would have caused an ownership change.[38a]

For purposes of the effective date rules, if there is an ownership change with respect to a subsidiary corporation as the result of the acquisition of the parent corporation, the subsidiary's treatment is governed by the nature of the parent-level transaction. For example, if all the stock of a parent corporation is acquired in a tax-free reorganization pursuant to a plan adopted before January 1, 1987, then the resulting indirect ownership change with respect to a subsidiary loss corporation will be treated as having occurred by reason of a reorganization pursuant to a plan adopted before January 1, 1987.

A reorganization plan will be considered adopted on the date that the boards of directors of all parties to the reorganization adopt the plans or recommend adoption to the shareholders, or on the date the shareholders approve, whichever is earlier. The parties' boards of directors may approve a plan of reorganization based on principles, and negotiations to date, and delegate to corporate officials the power to refine and execute a binding reorganization agreement, including a binding agreement subject to regulatory approval. Any subsequent board approval or ratification taken at the time of consummating the transaction as a formality (*i.e.*, that is not required, because the reorganization agreement is already legally binding under prior board approval) may occur without affecting the application of the effective date rule for reorganizations. In the case of a reorganization described in section 368(a)(1)(G) or an exchange of debt for stock in a Title 11 or similar case, the amendments do not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before August 14, 1986.

The earliest testing period under the Act begins on May 6, 1986 (the date of Senate Finance Committee action).[39] If an ownership change occurs after May 5, 1986, but before January 1, 1987, and section 382 and 383 (as amended by the Act) do not apply, then the earliest testing date will not begin before the first day following the date of such ownership change. For example, assume 60 percent of a loss corporation's stock (wholly owned by X) is purchased by B on May 29, 1986, and section 382 under the 1954 Code does not apply (because, for example, the loss corporation's business is continued and section 269 is not implicated). Assume further that X's remaining 40 percent stock interest is acquired by B on February 1, 1987. Under the Act, no ownership change occurs after the second purchase because the testing period begins on May 30, 1986, the day immediately after the ownership change; thus, an ownership change would not result from the second purchase. Conversely, if 40 percent of a loss corporation's stock (wholly owned by X) is purchased by D on July 1, 1986, and an additional 15 percent is purchased by P on January 15, 1987, then an ownership change would result from the second purchase, and the amendments would apply to limit the use of the loss corporation's NOL carryforwards.

[38a] A reorganization pursuant to a 1986 plan is thus treated under the Act as if the reorganization (and any ownership change resulting from the plan) occurred in 1986 when the plan was adopted. Other shifts in ownership in 1987 before completion of a 1986 plan are not protected.

[39] The Congress intended the May 6, 1986 date to apply for purposes of determining whether an ownership change occurred after May 5, 1986 but before January 1, 1987.

Moreover, if an ownership change that occurs after December 31, 1986 is not affected by the amendments to section 382 (because, for example, in the foregoing example the initial 40 percent stock purchase occurred on May 5, 1986, prior to the commencement of the testing period), the 1954 Code version of section 382 will remain applicable to the transaction. The 1954 Code version of section 382 is generally intended to have continuing application to any increase in percentage points to which the amendments made by the Act do not apply by application of any transitional rule, including the rules prescribing measurement of the testing period by reference only to transactions after May 5, 1986, and the rules grandfathering or disregarding ownership changes following or resulting from certain transactions.[40]

For purposes of determining whether shifts in ownership have occurred on or after May 6, 1986 and before December 31, 1986, the rule of section 382(l)(3)(A)(iv) in the case of options, and the similar rule in the case of any contingent purchase, warrant, convertible debt, stock subject to a risk of forfeiture, contract to acquire stock, or similar interests, shall apply. For example, in the case of such interests issued on or after May 6, 1986,[41a] the underlying stock could generally be treated as acquired at the time the interest was issued. However, for this transition period, it is expected that the Treasury Department may provide for a different treatment in the case of an acquisition of an option or other interest that is not in fact exercised, as appropriate where the effect of treating the underlying stock as if it were acquired would be to cause an ownership change that would be grandfathered under the transition rules and start a new testing period.

Contingent interests arising prior to January 1, 1987, for example, contingent options created in business transactions occurring prior to that date, are not treated as ownership changes merely by operation of the January 1, 1987, effective date. No inference is intended regarding the treatment of such contingent interests under the Act, other than to clarify that they are not treated as ownership changes merely by operation of the January 1, 1987 effective date.[41]

Special transitional rules are provided under which prior law continues to apply to certain ownership changes after January 1, 1987.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $9 million in 1987, $29 million in 1988, $39 million in 1989, $38 million in 1990, and $29 million in 1991.

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[40] A technical correction may be needed so that the statute reflects this intent.

[41a] No inference is intended as to how pre-May 6, 1986 options or other interests would be treated.

[41] *See* Floor statements by Mr. Rostenkowski, 132 *Cong. Rec.* H8363 (September 25, 1986) and 132 Cong. Rec. E 3390 (October 2, 1986); and Senators Dole and Packwood, 132 Cong. Rec. S 13958 (September 27, 1986).

G. Recognition of Gain or Loss on Liquidating Sales and Distributions of Property (*General Utilities*) (Secs. 631, 632, and 633 of the Act and secs. 336, 337, and 1374 of the Code) [42]

Prior Law

Overview

As a general rule, under prior law (as under present law) corporate earnings from sales of appreciated property were taxed twice, first to the corporation when the sale occurred, and again to the shareholders when the net proceeds were distributed as dividends. At the corporate level, the income was taxed at ordinary rates if it resulted from the sale of inventory or other ordinary income assets, or at capital gains rates if it resulted from the sale of a capital asset held for more than six months. With certain exceptions, shareholders were taxed at ordinary income rates to the extent of their pro rata share of the distributing corporation's current and accumulated earnings and profits.

An important exception to this two-level taxation of corporate earnings was the so-called *General Utilities* rule.[43] The *General Utilities* rule permitted nonrecognition of gain by corporations on certain distributions of appreciated property[44] to their shareholders and on certain liquidating sales of property. Thus, its effect was to allow appreciation in property accruing during the period it was held by a corporation to escape tax at the corporate level. At the same time, the transferee (the shareholder or third-party purchaser) obtained a stepped-up, fair market value basis under other provisions of the Code, with associated additional depreciation, depletion, or amortization deductions. Accordingly, the "price" of a step up in the basis of property subject to the *General Utilities* rule was typically a single capital gains tax paid by the shareholder on receipt of a liquidating distribution from the corporation.

Although the *General Utilities* case involved a dividend distribution of appreciated property by an ongoing business, the term "*General Utilities* rule" was often used in a broader sense to refer to the nonrecognition treatment accorded in certain situations to liquidating as well as nonliquidating distributions to shareholders and to liquidating sales. The rule was reflected in Code sections

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[42] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 331; H.Rep. 99-426, pp. 274-291; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 198-207 (Conference Report).

[43] *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

[44] Taxable gain may result on disposition of property even if the property's economic value remains constant (or decreases) over the taxpayer's holding period, due to tax depreciation and other downward adjustments to basis. The term "appreciated property" as used herein refers to property whose fair market value or sales price exceeds its adjusted (and not necessarily its original) basis in the hands of the transferor corporation.

311, 336, and 337 of prior law.[45] Section 311 governed the treatment of nonliquidating distributions of property (dividends and redemptions), while section 336 governed the treatment of liquidating distributions in kind. Section 337 provided nonrecognition treatment for certain sales of property pursuant to a plan of complete liquidation.

Numerous limitations on the *General Utilities* rule, both statutory and judicial, developed over the years following its codification. Some directly limited the statutory provisions embodying the rule, while others, including the collapsible corporation provisions, the recapture provisions, and the tax benefit doctrine, did so indirectly.

Case law and statutory background

Genesis of the General Utilities rule

The precise meaning of *General Utilities* was a matter of considerable debate in the years following the 1935 decision. The essential facts were as follows. General Utilities had purchased 50 percent of the stock of Islands Edison Co. in 1927 for $2,000. In 1928, a prospective buyer offered to buy all of General Utilities' shares in Islands Edison, which apparently had a fair market value at that time of more than $1 million. Seeking to avoid the large corporate-level tax that would be imposed if it sold the stock itself, General Utilities offered to distribute the Islands Edison stock to its shareholders with the understanding that they would then sell the stock to the buyer. The company's officers and the buyer negotiated the terms of the sale but did not sign a contract. The shareholders of General Utilities had no binding commitment upon receipt of the Islands Edison shares to sell them to the buyer on these terms.

General Utilities declared a dividend in an amount equal to the value of the Islands Edison stock, payable in shares of that stock. The corporation distributed the Islands Edison shares and, four days later, the shareholders sold the shares to the buyer on the terms previously negotiated by the company's officers.

The Internal Revenue Service took the position that the distribution of the Islands Edison shares was a taxable transaction to General Utilities. Before the Supreme Court, the Commissioner argued that the company had created an indebtedness to its shareholders in declaring a dividend, and that the discharge of this indebtedness using appreciated property produced taxable income to the company under the holding in *Kirby Lumber Co.* v. *United States*.[46] Alternatively, he argued, the sale of the Islands Edison stock was in reality made by General Utilities rather than by its shareholders following distribution of the stock. Finally, the Commissioner contended that a distribution of appreciated property by a corporation in and of itself constitutes a realization event. All dividends are distributed in satisfaction of the corporation's general obligation to pay out earnings to shareholders, he argued, and the satisfaction of that obligation with appreciated property causes a realization of the gain.

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[45] Unless otherwise indicated, all section references in this section (*"Prior Law"*) are to the Internal Revenue Code of 1954, as in effect immediately prior to the effective date of the amendments made by the Act.

[46] 284 U.S. 1 (1931).

The Supreme Court held that the distribution did not give rise to taxable income under a discharge of indebtedness rationale. The Court did not directly address the Commissioner's third argument, that the company realized income simply by distributing appreciated property as a dividend. There is disagreement over whether the Court rejected this argument on substantive grounds or merely on the ground it was not timely made. Despite the ambiguity of the Supreme Court's decision, however, subsequent cases interpreted the decision as rejecting the Commissioner's third argument and as holding that no gain is realized on corporate distributions of appreciated property to its shareholders.

Five years after the decision in *General Utilities*, in a case in which the corporation played a substantial role in the sale of distributed property by its shareholders, the Commissioner successfully advanced the imputed sale argument the Court had rejected earlier on procedural grounds. In *Commissioner* v. *Court Holding Co.*,[47] the Court upheld the Commissioner's determination that, in substance, the corporation rather than the shareholders had executed the sale and, accordingly, was required to recognize gain.

In *United States* v. *Cumberland Public Service Co.*,[48] the Supreme Court reached a contrary result where the facts showed the shareholders had in fact negotiated a sale on their own behalf. The Court stated that Congress had imposed no tax on liquidating distributions in kind or on dissolution, and that a corporation could liquidate without subjecting itself to corporate gains tax notwithstanding the primary motive is to avoid the corporate tax.[49]

In its 1954 revision of the Internal Revenue Code, Congress reviewed *General Utilities* and its progeny and decided to address the corporate-level consequences of distributions statutorily. It essentially codified the result in *General Utilities* by enacting section 311(a) of prior law, which provided that a corporation recognized no gain or loss on a nonliquidating distribution of property with respect to its stock. Congress also enacted section 336, which in its original form provided for nonrecognition of gain or loss to a corporation on distributions of property in partial or complete liquidation. Although distributions in partial liquidations were eventually removed from the jurisdiction of section 336, in certain limited circumstances a distribution in partial liquidation could, prior to the Act, still qualify for nonrecognition at the corporate level." [50]

Finally, Congress in the 1954 Act provided that a corporation did not recognize gain or loss on a sale of property if it adopted a plan of complete liquidation and distributed all of its assets to its shareholders within twelve months of the date of adoption of the plan (sec. 337). Thus, the distinction drawn in *Court Holding Co.* and *Cumberland Public Service Co.*, between a sale of assets followed by liquidating distribution of the proceeds and a liquidating distribution in kind followed by a shareholder sale, was in large part eliminated. Regulations subsequently issued under section 311 acknowledged that a distribution in redemption of stock constituted a "distribution with respect to . . . stock" within the meaning of the statute.[51] The 1954 Code in its original form, therefore, generally exempted all forms of nonliquidating as well as liquidating distributions to shareholders from the corporate-level tax.

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[47] 324 U.S. 331 (1945).

[48] 338 U.S. 451 (1950).

[49] Id. at 454-455.

[50] This exception for partial liquidations is discussed below under the heading "*Nonliquidating distributions.*

Nonliquidating distributions: section 311

Congress subsequently enacted a number of statutory exceptions to the *General Utilities* rule. Under prior law (as under present law), the presumption under *General Utilities* was reversed for nonliquidating distributions: the general rule was that a corporation recognized gain (but not loss) on a distribution of property as a dividend or in redemption of stock.[52] The distributing corporation is treated as if it sold the property for its fair market value on the date of the distribution. A number of exceptions to the general rule were provided. First, no gain was generally recognized to the distributing corporation with respect to distributions in partial liquidation made with respect to "qualified stock." Qualified stock was defined as stock held by noncorporate shareholders who at all times during the five-year period prior to the distribution (or the period the corporation had been in existence, if shorter) owned 10 percent or more in value of the distributing corporation's outstanding stock.[53]

Second, an exception from the general gain recognition rule was provided for a distribution with respect to qualified stock that constituted a "qualified dividend." A "qualified dividend" for this purpose was a dividend of property (other than inventory or receivables) used in the active conduct of certain "qualified businesses."[54] A "qualified business" was any trade or business that had been actively conducted for the five-year period ending on the date of the distribution and was not acquired in a transaction in which gain or loss was recognized in whole or in part during such period.[55] Thus, nonrecognition under this exception did not apply to distributions from holding companies or consisting of ordinary income property, and was limited to distributions to certain long-term, 10-percent shareholders other than corporations.

Third, an exception was provided for distributions with respect to qualified stock of stock or obligations in a subsidiary if substantially all of the assets of the subsidiary consisted of the assets of one or more qualified businesses, no substantial part of the subsidiary's nonbusiness assets were acquired in a section 351 transaction or as a capital contribution from the distributing corporation within the five-year period ending on the date of the distribution, and more than 50 percent in value of the stock of the subsidiary was distributed with respect to qualified stock.[56]

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[51] Treas. Reg. sec. 1.311-1(a).

[52] The statute (sec. 311(d)(1)(A)) by its terms applied only to "distribution[s] to which subpart A [of subchapter C, part I] applies . . . ."

[53] See secs. 311(d)(2)(A) and 302(b)(4) and (e). The Treasury Department was granted regulatory authority to prevent taxpayers not eligible for this special partial liquidation treatment from obtaining these benefits through the use of section 355, 351, 337, or other provisions of the Code or the regulations (sec. 346(b)).

[54] Sec. 311(e)(3).

[55] Sec. 311(e)(2)(B)(i).

[56] Sec. 311(d)(2)(B).

Finally, exceptions were provided for redemptions to pay death taxes, certain distributions to private foundations, and distributions by certain regulated investment companies in redemption of stock upon the demand of a shareholder.[57]

Section 311 also provided under separate rules that a corporation recognized gain on the distribution of encumbered property to the extent the liabilities assumed or to which the property was subject exceeded the distributing corporation's adjusted basis;[58] on the distribution of LIFO inventory, to the extent the basis of the inventory determined under a FIFO method exceeded its LIFO value;[59] and on the distribution of an installment obligation, to the extent of the excess of the face value of the obligation over the distributing corporation's adjusted basis in the obligation.[60]

Liquidating distributions and sales: sections 336 and 337

The rules regarding nonrecognition of gain on distributions in liquidation of a corporation were less restrictive than those applicable to nonliquidating distributions under prior law. Section 336 of prior law generally provided for nonrecognition of gain or loss by a corporation on the distribution of property in complete liquidation of the corporation. Gain was recognized, however, on a distribution of an installment obligation, unless the obligation was acquired in a liquidating sale that would have been tax-free under section 337, or the distribution was by a controlled subsidiary in a section 332 liquidation where the parent took a carryover basis under section 334(b)(1).[61] Section 336 also required recognition of the LIFO recapture amount in liquidating distributions.

Section 337 of prior law provided that if a corporation adopted a plan of complete liquidation and within twelve months distributed all of its assets in complete liquidation, gain or loss on any sales by the corporation during that period generally was not recognized. Section 337 did not apply, and recognition was required, on sales of inventory (other than inventory sold in bulk), stock in trade, and property held primarily for sale to customers in the ordinary course of business. If the corporation accounted for inventory on a LIFO basis, section 337 required that the LIFO recapture amount be included in income.

Distributions by S corporations

Under both prior and present law, a closely-held business operating in corporate form may elect to have business gains and losses taxed directly to or deducted directly by its individual shareholders. This election is available under subchapter S of the Code (secs. 1361-1379). The principal advantage of a subchapter S election to the owners of a business is the ability to retain the advantages of operating in corporate form while avoiding taxation of corporate earnings at both the corporate and shareholder levels.

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[57] Sec. 311(d)(2)(C), (D), (E).

[58] In the case of a distribution of property that was subject to a liability that was not assumed by the shareholder, the gain recognized was limited to the excess of the property's fair market value over its adjusted basis (sec. 311(c)). If the liability was nonrecourse, however, fair market value was treated as being not less than the amount of the liability (sec. 7701(g)).

[59] Sec. 311(b). Under the last-in, first-out or "LIFO" method of accounting, goods purchased or produced most recently are deemed to be the first goods sold. "FIFO" (first-in, first-out) accounting assumes that the first goods purchased or produced are the first goods sold. The LIFO recapture and installment obligation rules were applied before the recognition rules of section 311(d)(1).

[60] Sec. 453B. Installment obligations received by a corporation in a sale or exchange qualifying for nonrecognition under section 337 could be distributed to shareholders without recognition at the corporate level. Sec. 453B(d)(2).

[61] Sec. 453B(d).

Prior to 1983, shareholders of corporations making a subchapter S election were taxed on actual cash dividend distributions of current earnings and profits of the corporation, and on undistributed taxable income as a deemed dividend. Accordingly, all of the taxable income of a corporation taxable under subchapter S passed through to its shareholders as dividends. A shareholder increased his basis in his stock by the amount of his pro rata share of undistributed taxable income.

The Subchapter S Revision Act of 1982 substantially modified these rules. The dividends-earnings and profits system was abandoned in favor of a pass-through approach based more closely on the system under which partnership income is taxed. Under these new rules, gain must be recognized by an S corporation (which gain is passed through to its shareholders) on a nonliquidating distribution of appreciated property as if it had sold the property for its fair market value (sec. 1363(d)). The purpose of this rule is to assure that the appreciation does not escape tax entirely. A shareholder in an S corporation generally does not recognize gain on receipt of property from the corporation, but simply reduces his basis in his stock by the fair market value of the property, taking a basis in the property equal to that value. The shareholder can then sell the property without recognizing any gain. Thus, unless the distribution triggered gain at the corporate level, no current tax would be paid on the appreciation in the distributed property.

Under prior law, liquidating distributions by an S corporation were taxed in the same manner as liquidating distributions of C corporations. Thus, no gain was recognized by the corporation (secs. 1363(e) and 336). Although the *General Utilities* rule in this context was not responsible for the imposition of only a single, shareholder-level tax on appreciation in corporate property,[62] it could allow a portion of the gain that would otherwise be ordinary to receive capital gains treatment under prior law.

Statutory law and judicial doctrines affecting application of General Utilities rule

Recapture rules

The nonrecognition provisions of sections 311, 336, and 337 were subject to several additional limitations beyond those expressly set forth in those sections. These limitations included the statutory "recapture" rules for depreciation deductions, investment tax credits, and certain other items that might have produced a tax benefit for the transferor-taxpayer in prior years.[63]

The depreciation recapture rules (sec. 1245) required inclusion, as ordinary income, of any gain attributable to depreciation deductions previously claimed by the taxpayer with respect to "section 1245 property"—essentially, depreciable personal property—disposed of during the year, to the extent the depreciation claimed exceeded the property's actual decline in value.[64]

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[62] A shareholder would under the subchapter S rules be entitled to a basis increase equal to the amount of gain recognized by the corporation.

[63] These rules applied not just to corporate distributions but to sales and other dispositions of property, other than in tax-free reorganizations.

A more limited depreciation recapture rule applied to real estate. Under section 1250, gain on disposition of residential real property held for more than one year was recaptured as ordinary income to the extent prior depreciation deductions exceeded depreciation computed on the straight-line method. Gain on disposition of nonresidential real property held for more than one year, however, was generally subject to recapture of all depreciation unless a straight-line method had been elected, in which case there was no recapture.[65]

A number of other statutory recapture provisions could apply to a liquidating or nonliquidating distribution of property, including section 617(d) (providing for recapture of post-1965 mining exploration expenditures), section 1252 (soil and water conservation and land-clearing expenditures), and section 1254 (post-1975 intangible drilling and development costs).

Collapsible corporation rules

Under prior law (as under present law), section 341 modified the tax treatment of transactions involving stock in or property held by "collapsible" corporations. In general, a collapsible corporation was one the purpose of which was to convert ordinary income into capital gain through the sale of stock by its shareholders, or through liquidation of the corporation, before substantial income had been realized.

Under section 341, if a shareholder disposed of stock in a collapsible corporation in a transaction that would ordinarily produce long-term capital gain, the gain was treated as ordinary income. Likewise, any gain realized by a shareholder on a liquidating distribution of property from a collapsible corporation was ordinary income. Finally, prior law section 337 was inapplicable in the case of a collapsible corporation. Thus, liquidating sales of appreciated inventory or other property held by the corporation for sale to customers generated ordinary income that was fully recognized at the corporate level.[66]

Certain stock purchases treated as asset purchases

Under both prior and present law, section 338 permits a corporation that purchases a controlling stock interest in another corporation (the "target" corporation) within a twelve-month period to elect to treat the transaction as a purchase of the assets of that corporation for tax purposes. If the election is made, the target is treated as if it had sold all of its assets pursuant to a plan of complete liquidation on the date the purchaser obtained a controlling interest in the target (the "acquisition date"), for an amount essentially equal to the purchase price of the stock plus its liabilities. Under prior law, this deemed sale was regarded as occurring under 337. Accordingly, no gain was recognized on the deemed sale other than gain attributable to section 1245 or other provisions that override section 337. The target was then treated as a newly organized corporation which purchased all of the "old" target's assets for a price essentially equal to the purchase price of the stock plus the old target's liabilities on the beginning of the day after the qualified stock purchase. Thus, the new target corporation was able to obtain a stepped-up basis in its assets equal to their fair market value.

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[64] In the case of sales or exchanges of property in taxable transactions, the effect of this provision was to convert a portion of what would otherwise be capital gain into ordinary income. In the case of nonrecognition transactions, the effect was to require recognition of gain that would otherwise have gone unrecognized.

[65] Sec. 1245(a)(5). See also sec. 291(a), subjecting a portion of the straight-line depreciation on real estate to recapture in the case of corporations.

[66] It was possible for gain on sales of capital or section 1231 assets in a section 337 liquidation of a collapsible corporation to be eligible for taxation at capital gains rates. A sale in liquidation could produce corporate level income that eliminated the collapsible status of the corporation, so that the shareholders were eligible for capital gains treatment on any gain realized on relinquishment of their shares in the liquidation.

Prior to the enactment of section 338, similar results could be achieved under section 332 and former section 334(b)(2) by liquidating the acquired corporation into its parent within a specified period of time. One abuse Congress sought to prevent in enacting section 338 was selective tax treatment of corporate acquisitions. Taxpayers were able to take a stepped-up basis in some assets held by a target corporation or its affiliates while avoiding recapture tax and other unfavorable tax consequences with respect to other assets.[67] Section 338 contains elaborate "consistency" rules designed to prevent selectivity with respect to acquisitions of stock and assets of a target corporation (and its affiliates) by an acquiring corporation (and its affiliates). All such purchases by the acquiring group must be treated consistently as either asset purchases or stock purchases if they occur within the period beginning one year before and ending one year after the twelve-month acquisition period.[68]

Section 338 of prior (and present) law contained an alternative election under which, in certain circumstances, a corporate purchaser and a seller of an 80-percent-controlled subsidiary could elect to treat the sale of the subsidiary stock as if it had been a sale of the underlying assets. Among the requirements for the filing of an election under section 338(h)(10) were that the selling corporation and its target subsidiary must be members of an affiliated group filing a consolidated return for the taxable year that included the acquisition date. If an election was made, the underlying assets of the corporation that was sold received a stepped-up, fair market value basis; the selling consolidated group recognized the gain or loss attributable to the assets; and there was no separate tax on the seller's gain attributable to the stock. This provision offered taxpayers relief from a potential multiple taxation at the corporate level of the same economic gain, which could result when a transfer of appreciated corporate stock was taxed without providing a corresponding step-up in basis of the assets of the corporation.

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[67] Prior to TEFRA, a step-up could be achieved through a partial liquidation of the target as well as a complete liquidation under sections 332 and 334(b)(2).

[68] Exceptions are provided for assets acquired in the ordinary course of business, acquisitions in which the basis of property is carried over, and other asset acquisitions as provided in regulations.

Judicially created doctrines

Under prior law, the courts applied nonstatutory doctrines from other areas of the tax law to in-kind distributions to shareholders. These doctrines also apply under present law. For example, it was held that, where the cost of property distributed in a liquidation or sold pursuant to a section 337 plan of liquidation had previously been deducted by the corporation, the tax benefit doctrine overrode the statutory rules to cause recognition of income.[69] The application of the tax benefit doctrine turns on whether there is a "fundamental inconsistency" between the prior deduction and some subsequent event.[70]

The courts also applied the assignment of income doctrine to require a corporation to recognize income on liquidating and nonliquidating distributions of its property.[71]

Reasons for Change

In general

Congress believed that the *General Utilities* rule, even in its more limited form, produced many incongruities and inequities in the tax system. First, the rule could create significant distortions in business behavior. Economically, a liquidating distribution is indistinguishable from a nonliquidating distribution; yet the Code provided a substantial preference for the former. A corporation acquiring the assets of a liquidating corporation was able to obtain a basis in assets equal to their fair market value, although the transferor recognized no gain (other than possibly recapture amounts) on the sale. The tax benefits made the assets potentially more valuable in the hands of a transferee than in the hands of the current owner. This might induce corporations with substantial appreciated assets to liquidate and transfer their assets to other corporations for tax reasons, when economic considerations might indicate a different course of action. Accordingly, Congress reasoned, the *General Utilities* rule could be at least partly responsible for the dramatic increase in corporate mergers and acquisitions in recent years. Congress believed that the Code should not artificially encourage corporate liquidations and acquisitions, and that repeal of the *General Utilities* rule was a major step towards that goal.

Second, the *General Utilities* rule tended to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the *General Utilities* rule applied, assets generally were permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax.[72] Thus, the effect of the rule was to grant a permanent exemption from the corporate income tax.

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[69] See, *e.g.*, *Bliss Dairy* v. *United States*, 460 U.S. 370 (1983) and *Tennessee Carolina Transportation, Inc.* v. *Commissioner*, 65 T.C. 440 (1975), *aff'd* 582 F.2d 378 (6th Cir. 1978) (liquidating distribution of previously expensed items); *Estate of Munter* v. *Commissioner*, 63 T.C. 663 (1975) (sale of previously deducted items pursuant to plan of liquidation).

[70] *Bliss Dairy*, supra.

[71] *E.g.*, *Commissioner* v. *First State Bank*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948) (a decision rendered prior to the enactment of sec. 311); *Siegel* v. *United States*, 464 U.S. 891 (1972), *cert. dism'd*, 410 U.S. 918 (1973).

Anti-tax avoidance provisions

In repealing the *General Utilities* rule, which provided for nonrecognition of losses as well as gains on distributions, Congress was concerned that taxpayers might utilize various means (including other provisions of the Code or the Treasury regulations) to circumvent repeal of the rule or, alternatively, might exploit the provision to realize losses in inappropriate situations or inflate the amount of the losses actually sustained. For example, under the general rule permitting loss recognition on liquidating distributions, taxpayers might be able to create artificial losses at the corporate level or to duplicate shareholder losses in corporate solution through contributions of property having previously accrued ("built-in") losses. In an effort to prevent these potential abuses, Congress included in the Act regulatory authority to prevent circumvention of the purposes of the amendments through use of any provision of law or regulations. In addition, it included specific statutory provisions designed to prevent avoidance of tax on corporate-level gains through conversions to subchapter S corporation status and unwarranted recognition of losses at the corporate level.

Conforming changes to provisions relating to nonliquidating distributions

The tax treatment of corporations with respect to nonliquidating distributions of appreciated property historically has been the same as liquidating distributions. In recent years, however, nonliquidating distributions have been subjected to stricter rules than liquidating distributions, and corporations have generally been required to recognize gain as a result of nonliquidating distributions of appreciated property. Consistent with this relationship, the Act generally conforms the treatment of nonliquidating distributions with liquidating distributions.

Relief from repeal of the General Utilities rule

Several exceptions to the recognition requirement are provided in the Act. The first relates to distributions of the stock and securities of a controlled subsidiary which under prior law (as under the Act) the distributee shareholder may receive tax-free pursuant to section 355. Congress felt that the same policy rationale that justifies nonrecognition by the shareholder on receipt of the stock—namely, that the transfer merely effects a readjustment of the shareholder's continuing interest in the corporation in modified form and subject to certain statutory and other constraints—also justifies nonrecognition of gain (or loss) to the distributing corporation in this situation. Similarly, certain distributions pursuant to a plan of reorganization also are not subject to recognition.[73]

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[72] The price of this basis step up was, at most, a single, shareholder-level capital gains tax (and perhaps recapture, tax benefit, and other similar amounts). In some cases, moreover, payment of the capital gains tax was deferred because the shareholder's gain was reported under the installment method.

[73] See secs. 311 and 336 as amended by the Act. See also 361 as amended by the Act.

Another exception relates to certain section 332 liquidations in which an 80-percent corporate shareholder receives property with a carryover basis. Congress believed that this exception was justified on the ground that the property (together with the other attributes of the liquidated subsidiary) is retained within the economic unit of the affiliated group. Because such an intercorporate transfer within the group is a nonrecognition event, carryover basis follows. As a result of the carryover basis, the corporate level tax will be paid if the distributed property is disposed of by the recipient corporation to a person outside of the group. Where gain recognition with respect to the distributed property would not be preserved (*e.g.*, certain transfers to a tax-exempt or foreign corporate parent), the exception for liquidating distributions to an 80-percent corporate shareholder does not apply.[74]

Election to treat sales or distributions of certain subsidiary stock as asset transfers

Congress believed it was appropriate to conform the treatment of liquidating and nonliquidating sales or distributions and to require recognition when appreciated property, including stock of a subsidiary, is transferred to a corporate or individual recipient outside the economic unit of the selling or distributing affiliated group. Thus, the Act provides that such transactions result in the recognition of gain or loss to the parent corporation on the appreciation in the stock (that is, on the "outside" gain). There is a potential multiple taxation at the corporate level of the same economic gain, which may result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the "inside" assets of the corporation. (In many cases, however, the "outside" gain may be less than the "inside" gain; furthermore, the deferral of such "inside" gain may significantly reduce any actual economic multiple corporate taxation effect). Congress believed it was appropriate to permit an election to recognize the inside gain immediately in lieu of the outside gain, thus in effect treating the transaction as a transfer of the underlying assets. Such an election was already available under prior law in some circumstances under section 338(h)(10).[75] However, this election was not available, for example, when the subsidiary did not file a consolidated return with the selling shareholder, or when the stock of the subsidiary was distributed to shareholders.[76] Congress granted regulatory authority to the Treasury Department to expand the scope of the election to treat the sale of a corporation's stock as a sale of its underlying assets to include sales not covered by section 338(h)(10) and distributions of stock in a controlled subsidiary.

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[74] In amending section 311 in 1984, Congress determined that the existence of a carryover basis in the hands of a corporate distributee, even where the distributee was a member of the same affiliated group, did not justify nonrecognition for nonliquidating distributions. Nonliquidating distributions present opportunities for selective transfer of gain or loss that were not believed to be present in a corporate liquidation qualifying for relief. *See*, H. Rep. 98-861 (June 23, 1984), p. 821.

[75] As discussed above, section 338(h)(10) permits an election under which the selling corporation's gain on the sale of its subsidiary's stock is ignored, and gain is recognized by the subsidiary as if it had sold its assets in a taxable sale and then liquidated in a section 332 liquidation.

[76] Distributions of subsidiary stock may qualify for nonrecognition at both the corporate and shareholder levels if the requirements of section 355 are met. However, specific statutory requirements, including a five-year active business test, must be met before section 355 is applicable.

Explanation of Provisions

Overview

The Act provides that gain or loss generally is recognized by a corporation on liquidating distributions of its property as if the property had been sold at fair market value to the distributee. Gain or loss is also recognized by a corporation on liquidating sales of its property. Exceptions are provided for distributions in which an 80-percent corporate shareholder receives property with a carryover basis in a liquidation under section 332, and certain distributions and exchanges involving property that may be received tax-free by the shareholder under subchapter C of the Code.

The Act also makes certain conforming changes in the provisions relating to nonliquidating distributions of property to shareholders, and in the provisions relating to corporations taxable under subchapter S.

Distributions in complete liquidation

General rule

The Act provides that, in general, gain or loss is recognized to a corporation on a distribution of its property in complete liquidation. The distributing corporation is treated as if it had sold the property at fair market value to the distributee-shareholders.

If the distributed property is subject to a liability, the fair market value of the property for this purpose is deemed to be no less than the amount of the liability. Thus, for example, if the amount of the liability exceeds the value of the property that secures it, the selling corporation will recognize gain in an amount equal to the excess of the liability over the adjusted basis of the property.[77] Likewise, if the shareholders of the liquidating corporation assume liabilities of the corporation and the amount of liabilities assumed exceeds the fair market value of the distributed property, the corporation will recognize gain to the extent the assumed liabilities exceed the adjusted basis of the property. However, the provision does not affect, and no inference was intended regarding, the amount realized by or basis of property received by the distributee-shareholders in these circumstances.

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[77] *See also* section 7701(g) of the Code, providing that an identical rule for nonrecourse debt applies with respect to *any* Code provision (including secs. 336 and 311) in which the amount of gain realized with respect to certain transfers or dispositions is determined by specific reference to the fair market value of the property directly or indirectly disposed of. Treas. Reg. secs. 1.1001-1 and 1.1001-2 also provide generally for the treatment of transfers in which recourse or nonrecourse liabilities are involved. As under these provisions, Congress did not intend to require that any liabilities incurred by reason of the acquisition of property that were not taken into account in determining the transferor's basis for such property be taken into account in determining the amount of gain or loss under this provision.

Exceptions

Section 332 liquidations[78]

An exception to the recognition rule is provided for certain distributions in connection with the liquidation of a controlled subsidiary into its parent corporation. Under new section 337 of the Code, no gain or loss is generally recognized with respect to property distributed to a corporate shareholder (an "80-percent distributee") in a liquidation to which section 332 applies. If a minority shareholder receives property in such a liquidation, the distribution to the minority shareholder is treated in the same manner as a distribution in a nonliquidating redemption. Accordingly, gain (but not loss) is recognized to the distributing corporation.[79]

The exception for 80-percent corporate shareholders does not apply where the shareholder is a tax-exempt organization unless the property received in the distribution is used by the organization in an activity, the income from which is subject to tax as unrelated business taxable income (UBTI), immediately after the distribution. If such property later ceases to be used in an activity of the organization acquiring the property, the income from which is subject to tax as UBTI, the organization will be taxed at that time (in addition to any other tax imposed, for example, on depreciation recapture under section 1245) on the lesser of (a) the built-in gain in the property at the time of the distribution, or (b) the difference between the adjusted basis of the property and its fair market value at the time of the cessation.

The exception for liquidations into a controlling corporate shareholder is also inapplicable where the parent is a foreign corporation. The Act amends section 367 of the Code to require recognition in a liquidation into a controlling foreign corporation, unless regulations provide otherwise. Congress expected that such regulations may permit nonrecognition if the potential gain on the distributed property at the time of the distribution is not being removed from the U.S. taxing jurisdiction prior to recognition.

If gain is recognized on a distribution of property in a liquidation described in section 332(a), a corresponding increase in the distributee's basis in the property will be permitted.[80]

The Act relocates the provisions of section 332(c) to section 337(c) of the Code. Distributions of property to the controlling parent corporation in liquidations to which section 332 applies in exchange for debt obligations of the subsidiary are treated in the same manner as distributions in exchange for stock of the subsidiary, as under prior law section 332(c).

Tax-free reorganizations and distributions

The general rule requiring gain or loss recognition on liquidating distributions of property is inapplicable to transactions governed by Part III of subchapter C of the Code, relating to corporate organizations and reorganizations, to the extent the recipient may receive the property without recognition of gain (*i.e.*, to the extent the recipient does not receive "boot").[81] In addition, the provision is not intended to apply to nonreorganization transactions described in section 355 of the Code to the extent the recipient may receive the distribution without recognition of gain under Part III of subchapter C.[82] Thus, on a liquidating distribution of boot in a transaction qualifying under section 355 that is not pursuant to a plan of reorganization, the distributing corporation recognizes gain (but not loss) with respect to any "boot" distributed to shareholders.[83]

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[78] Congress anticipated that, in a consolidated return context, the Treasury Department will consider whether aggregation of ownership rules similar to those in sec. 1.1502-34 of the regulations should be provided for purposes of determining a corporation's status as an 80-percent distributee.

[79] See sec. 336(d)(3) of the Code, as amended by the Act.

[80] A technical correction may be needed so that the statute reflects this intent.

Limitations on recognition of losses

The Act includes two provisions designed to prevent inappropriate corporate-level recognition of losses on liquidating dispositions of property. In enacting these provisions, Congress did not intend to create any inference regarding the deductibility of such losses under other statutory provisions or judicially created doctrines, or to preclude the application of such provisions or doctrines where appropriate.[84]

Distributions to related persons

Under the first loss limitation rule, a liquidating corporation may not recognize loss with respect to a distribution of property to a related person within the meaning of section 267,[85] unless (i) the property is distributed to all shareholders on a pro rata basis *and* (ii) the property was not acquired by the liquidating corporation in a section 351 transaction or as a contribution to capital during the five years preceding the distribution.

Thus, for example, a liquidating corporation may not recognize loss on a distribution of recently acquired property to a shareholder who, directly or indirectly, owns more than 50 percent in value of the stock of the corporation. Similarly, a liquidating corporation may not recognize a loss on any property, regardless of when or how acquired, that is distributed to such a shareholder on a non-pro rata basis.

Dispositions of certain carryover basis property acquired for tax-avoidance purpose

Under the second loss limitation rule, recognition of loss may be limited if property whose adjusted basis exceeds its value is contributed to a liquidating corporation, in a carryover basis transaction, with a principal purpose of recognizing the loss upon the sale or distribution of the property (and thus eliminating or otherwise limiting corporate level gain). In these circumstances, the basis of the property for purposes of determining loss is reduced, but not below zero, by the excess of the adjusted basis of the property on the date of contribution over its fair market value on such date.[86]

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[81] Section 361 provides rules governing the treatment of certain distributions in a reorganization. Under amended section 361, sections 336 and 337 do not apply to distributions of property pursuant to a plan of reorganization.

[82] A technical correction may be needed so that the statute reflects this intent.

[83] A technical correction may also be needed to clarify that the distributing corporation recognizes gain but not loss on a distribution of boot in these circumstances.

[84] See, *e.g.*, section 482 and Treas. Reg. section 1.482-1(d)(5); *National Securities Corp.* v. *Comm'r*, 137 F.2d 600 (3d Cir. 1943), aff'g 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943) (loss on sale by subsidiary of securities transferred by parent in nonrecognition transaction reallocated to parent, where purpose of transfer was to shift unrealized loss on securities to subsidiary); *Court Holding Co.* v. *U.S.*, 324 U.S. 321 (1945) (corporation treated as true seller of property distributed to shareholders and purportedly sold by them to third party); and *Gregory* v. *Helvering*, 293 U.S. 465 (1935) (in addition to meeting literal requirements of statute, transaction must have valid business purpose to qualify for nonrecognition).

[85] This was intended to refer to a person having a relationship to the distributing corporation that is described in section 267(b).

If the adoption of a plan of complete liquidation occurs in a taxable year following the date on which the tax return including the loss disallowed by this provision is filed, except as provided in regulations, the liquidating corporation will recapture the disallowed loss on the tax return for the taxable year in which such plan of liquidation is adopted. In the alternative, regulations may provide for the corporation to file an amended return for the taxable year in which the loss was reported.[87]

Example

The application of the basis reduction rule can be illustrated by the following example:

Assume that on June 1, 1987, a shareholder who owns 10 percent of the stock of a corporation (which is a calendar year taxpayer) participates with other shareholders in a contribution of property to the corporation that qualifies for nonrecognition under section 351, contributing nondepreciable property with a basis of $1,000 and a value of $100 to the corporation. Also assume that a principal purpose of the acquisition of the property by the corporation was to recognize loss by the corporation and offset corporate-level income or gain in anticipation of the liquidation. On September 30, 1987, the corporation sells the property to an unrelated third party for $200, and includes the resulting $800 loss on its 1987 tax return. Finally, the corporation adopts a plan of liquidation on December 31, 1988.

For purposes of determining the corporation's loss on the sale of the property in 1987, the property's basis is reduced to $100 — that is, $1,000 (the transferred basis under section 362) minus $900 (the excess of the property's basis over its value on the date of contribution). No loss would be realized on the sale, since the corporation received $200 for the property. Likewise, the corporation would recognize no gain on the sale, since its basis for purposes of computing gain is $1,000. Congress expected that regulations might provide for the corporation to file an amended return for 1987 reflecting no gain or loss on the sale of the property. Otherwise, the corporation would be required to reflect the disallowance of the loss by including the amount of the disallowed loss on its 1988 tax return.[88]

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[86] The effect of the rule is to deny recognition to the liquidating corporation of that portion of the loss on the property that accrued prior to the contribution, but to permit recognition of any loss accruing after the contribution. In the event that a transaction is described both in section 336(d)(1) and section 336(d)(2), section 336(d)(1) will prevail.

This provision was not intended to override section 311(a). Thus, if property is distributed in a nonliquidating context, the entire loss (and not merely the built-in loss) will be disallowed.

[87] A technical correction may be needed so that the statute reflects the intention that recapture in the year of liquidation is required unless regulations provide otherwise.

[88] *See* footnote 87, *supra*.

Presumption of tax-avoidance purpose in case of contributions within two years of liquidation

For purposes of the loss limitation rule, there is a statutory presumption that the tax-avoidance purpose is present with respect to any section 351 transfer or contribution to capital of built-in loss property within the two-year period prior to the adoption of the plan of liquidation (or at any time thereafter). Although Congress recognized that a contribution more than two years before the adoption of a plan of liquidation might have been made for such a tax-avoidance purpose, Congress also recognized that the determination that such purpose existed in such circumstances might be difficult for the Internal Revenue Service to establish and therefore as a practical matter might occur infrequently or in relatively unusual cases.

Congress intended that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property within two years of the adoption of a plan of liquidation will be disregarded *unless* there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises.

A clear and substantial relationship between the contributed property and the conduct of the corporation's business enterprises would generally include a requirement of a corporate business purpose for placing the property in the particular corporation to which it was contributed, rather than retaining the property outside that corporation. If the contributed property has a built-in loss at the time of contribution that is significant in amount as a proportion of the built-in corporate gain at that time, special scrutiny of the business purpose would be appropriate.

As one example, assume that A owns Z Corporation which operates a widget business in New Jersey. That business operates exclusively in the northeastern region of the United States and there are no plans to expand those operations. In his individual capacity, A had acquired unimproved real estate in New Mexico that has declined in value. On March 22, 1988, A contributes such real estate to Z and six months later a plan of complete liquidation is adopted. Thereafter, all of Z's assets are sold to an unrelated party and the liquidation proceeds are distributed. A contributed no other property to Z during the two-year period prior to the adoption of the plan of liquidation. Because A contributed the property to Z less than two years prior to the adoption of the plan of liquidation, it is presumed to have been contributed with a prohibited purpose. Moreover, because there is no clear and substantial relationship between the contributed property and the conduct of Z's business, Congress did not expect that any loss arising from the disposition of the New Mexico real estate would be allowed under the Treasury regulations.

However, Congress expected that such regulations will permit the allowance of any resulting loss from the disposition of any of the assets of a trade or business (or a line of business) that are contributed to a corporation where prior law would have permitted the allowance of the loss and the clear and substantial relationship test is satisfied. In such circumstances, application of the loss disallowance rule is inappropriate assuming there is a meaningful (i.e., clear and substantial) relationship between the contribution and the utilization of the particular corporate form to conduct a business enterprise. If the contributed business is disposed of immediately after the contribution it is expected that it would be particularly difficult to show that the clear and substantial relationship test was satisfied. Congress also anticipated that the basis adjustment rules will generally not apply to a corporation's acquisition of property as part of its ordinary start-up or expansion of operations during its first two years of existence. However, if a corporation has substantial substantial gain assets during its first two years of operation, a contribution of substantial built-in loss property followed by a sale or liquidation of the corporation would be expected to be closely scrutinized.

Conversions from C to S corporation status

The Act modifies the treatment of an S corporation that was formerly a C corporation. A corporate-level tax is imposed on any gain that arose prior to the conversion ("built-in" gain) and is recognized by the S corporation, through sale, distribution or other disposition[89] within ten years after the date on which the S election took effect. The total amount of gain that must be recognized by the corporation, however, is limited to the aggregate net built-in gain of the corporation at the time of conversion to S corporation status.[90] Congress expected that the Treasury Department could prevent avoidance of the built-in gain rule by contributions of built-in loss property prior to the conversion for the purpose of reducing the net built-in gain.

Gains on sales or distributions of assets by the S corporation are presumed to be built-in gains, except to the extent the taxpayer establishes that the appreciation accrued after the conversion, such as where the asset was acquired by the corporation in a taxable acquisition after the conversion. Built-in gains are taxed at the maximum corporate rate applicable to the particular type of income (i.e., the maximum rate on ordinary income under section 11 or, if applicable, the alternative rate on capital gain income under section 1201) for the year in which the disposition occurs. The corporation may take into account all of its subchapter C tax attributes in computing the amount of the tax on recognized built-in gains. Thus, for example, it may use unexpired net operating losses, capital loss carryovers, and similar items to offset the gain or the resulting tax.[91]

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[89] For the particular purposes of this built-in gain tax under new section 1374, Congress intended the term "disposition of any asset" to include not only sales or exchanges but other income-recognition events that effectively dispose of or relinquish the taxpayer's right to claim or receive income. For instance, the term "disposition of any asset" for purposes of this provision will include the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

[90] Congress intended that the recognized built-in gains taken into account for any taxable year shall not exceed the excess, if any, of (a) the net unrealized built-in gain at the time of the conversion, over (b) the amount (if any) by which recognized built-in gains for prior taxable years beginning in the recognition period exceed recognized built-in losses for such years.

[91] A technical correction may be needed so that the statute reflects this intent in the case of capital loss carryovers and similar items.

Congress intended that in a carryover basis transfer of property with built-in gain to an S corporation from a C corporation, the built-in gain with respect to property will be preserved in the hands of the transferee for the 10-year period. Similarly, in the case of a transfer of built-in gain property in a substituted basis transaction, the property received by the transferor will assume the built-in gain taint of the transferred property. If a C corporation converts to S status and is subject to the built-in gain rule, built-in gain assets that such corporation transfers to another S corporation in a carryover basis transaction will retain their original 10-year taint in the hands of the transferee.

Regulatory authority to prevent circumvention of General Utilities repeal

The repeal of the *General Utilities* rule is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context. Congress expected the Treasury Department to issue, or to amend, regulations to ensure that the purpose of the new provisions (including the new subchapter S built-in gain provisions) is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (part III of subchapter C) or through the use of other pass-through entities such as regulated investment companies (RICs) or real estate investment trusts (REITs). For example, this would include rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT in a carryover basis transaction that would otherwise eliminate corporate-level tax on the built-in appreciation.

Application of other statutory rules and judicial doctrines

In providing for recognition of gain on liquidating distributions, Congress did not intend to supersede other existing statutory rules and judicial doctrines, including (but not limited to) section 1245 and 1250 recapture, the tax benefit doctrine, and the assignment of income doctrine. Accordingly, these rules will continue to apply to determine the character of gain recognized on liquidating distributions where they are otherwise applicable.

Nonliquidating distributions

The Act makes certain conforming changes to the provisions relating to nonliquidating distributions of property. For purposes of determining the amount realized on a distribution of property, the fair market value of the property is treated as being no less than the amount of any liability to which it is subject or which is assumed by the shareholder under the principles applicable to liquidating distributions. The prior-law exceptions to recognition that were provided for nonliquidating distributions to ten percent, long-term noncorporate shareholders, and for certain distributions of property in connection with the payment of estate taxes or in connection with certain redemptions of private foundation stock, are repealed. As under prior law, no loss is recognized to a distributing corporation on a nonliquidating distribution of property to its shareholders.

Election to treat sale or distribution of subsidiary stock as disposition of subsidiary's assets

The Act generally conforms the treatment of liquidating sales and distributions of subsidiary stock to the prior-law treatment of nonliquidating sales or distributions of such stock; thus, such liquidating sales or distributions are generally taxable at the corporate level. Congress believed it was appropriate to conform the treatment of liquidating and nonliquidating sales or distributions and to require recognition when appreciated property, including stock of a subsidiary, is transferred to a corporate or individual recipient outside the economic unit of the selling or distributing corporation.

However, Congress believed it was appropriate to provide relief from a potential multiple taxation at the corporate level of the same economic gain, which may result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the assets of the corporation. In addition to retaining the election available under section 338(h)(10) of prior law, the Act permits the expansion of the concept of that provision, to the extent provided in regulations, to dispositions of a controlling interest in a corporation for which this election is currently unavailable. For example, the election could be made available where the selling corporation owns 80 percent of the value and voting power of the subsidiary but does not file a consolidated return with the subsidiary. Moreover, the Act provides that, under regulations, principles similar to those of section 338(h)(10) may be applied to taxable distributions of controlled corporation stock.[92]

Congress intended that the regulations under this elective provision will account for appropriate principles that underlie the liquidation-reincorporation doctrine. For example, to the extent that regulations make available an election to treat a stock transfer of controlled corporation stock to persons related to such corporation within the meaning of section 368(a)(2)(H) (i.e., section 304(c)), it may be appropriate to provide special rules for such corporation's section 381(c) tax attributes so that net operating losses may not be used to offset liquidation gains, earnings and profits may not be manipulated, or accounting methods may not be changed.

Congress did not intend this election to affect the manner in which a corporation's distribution to its shareholders is characterized for purposes of determining the shareholder level income tax consequences.

Treasury study of subchapter C

The Act directs the Treasury Department to consider whether changes to the provisions of subchapter C (relating to the income taxation of corporations and their shareholders) and related sections of the Code are desirable, and to report to the tax-writing committees of Congress no later than January 1, 1988.

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[92] The Act provides in the case of a sale or distribution of stock of a subsidiary by a qualifying parent corporation, that under regulations "such corporation" may make the election. Congress did not intend to require the election to be made unilaterally. Compare section 338(h)(10).

Effective Dates

In general

The repeal of the *General Utilities* rule is generally effective for liquidating sales and distributions after July 31, 1986. The Act provides a number of general transitional rules, some of which are based on action before November 20, 1985 (the date of action by the House Ways and Means Committee), some of which are based on action before August 1, 1986 (the date of action by the conference committee), and some of which are based on actions after July 31, 1986, and before January 1, 1987. The amendments made by the Act are inapplicable to transactions covered by these general transitional rules.

In addition to these general transitional rules, the Act provides a special delayed effective date for transactions involving certain closely held corporations of limited size. With certain modifications, these transactions are also subject to prior-law rules.

General transitional rules based on pre-November 20, 1985 action

The amendments made by the Act do not apply to distributions or sales and exchanges made pursuant to a plan of liquidation adopted before November 20, 1985, provided the liquidation is completed before January 1, 1988. Special rules apply in determining whether a plan of liquidation was adopted for purposes of these transitional rules[93] and whether a distribution, sale, or exchange is made pursuant to such a plan of liquidation. In general, the rules are intended to provide relief in situations in which a decision to liquidate has clearly been made regarding an acquisition, or a decision regarding acquisition has been made and the essential terms have been determined. Some transactions may qualify for relief under more than one provision. A liquidation will be treated as completed under the same standard that is applied under the general transitional rules for liquidations before January 1, 1987.

First rule

The first rule under which a distribution, sale or exchange is treated as pursuant to a plan of liquidation adopted before November 20, 1985, looks to action taken by the liquidating company before the November 20 date. If the board of directors of that company adopted a resolution to solicit shareholder approval for a transaction described in section 336 or 337 of prior law[94] or if the shareholders or board of directors of the liquidating company have approved such a transaction, then distributions, sales and exchanges that occur pursuant to the transaction are not subject to the Act provided that the liquidation is completed before January 1, 1988.

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[93] These special rules do not apply, however, for purposes of the transitional rules based on pre-August 1, 1986, action.

[94] For purposes of these transitional rules generally, transactions described in section 336 or 337 of prior law include complete liquidations and the related distributions, sales or exchanges described in those sections.

Pre-November 20 action

For purposes of this first rule, certain actions taken before November 20, 1985, were intended to constitute implicitly the necessary board or directors or shareholder approval even though formal board of shareholder approval may not otherwise have occurred before that date. Congress intended the requisite board or shareholder approval will be deemed to have occurred if, before November 20, 1985, there was sufficient written evidence to establish that a decision to liquidate has been approved by the board of directors or shareholders, even though the approval may have been given informally, as may occur, for example, in a closely held setting. Examples of sufficient written evidence include written contacts with third parties indicating the decision to liquidate and seeking any necessary approvals for asset transfers or for other actions in connection with the liquidation.

Congress also intended that the requisite board or shareholder approval would be deemed to have occurred, if a company had, before November 20, 1985, entered into a binding contract to sell substantially all of its assets, or entered into a letter of intent with a buyer specifying the essential terms of such a contract.[95] Similarly, the requisite approval would be deemed to have occurred if, before the relevant date, the board of directors of a corporation adopted a resolution approving or recommending the grant by its shareholders of an option to purchase a majority of the stock of the corporation; or if the shareholders granted such an option before the relevant date, if the option in each case would be a binding option as to the seller, enforceable by the optionee (purchaser).

"Pursuant to" requirement

To qualify for transitional relief, distributions, sales or exchanges must be pursuant to the transaction that the board of directors approved, or for which it solicited shareholder authority (as described above). This will generally be presumed to be the case if a formal plan of liquidation is adopted and the distributions, or sales and exchanges pursuant to such plan commence within one year of the original shareholder or board action. If such action is not taken within a year of such time, all the facts and circumstances must be considered, including, for example, a decision to seek a ruling request from the Internal Revenue Service or the need to obtain governmental rulings or approvals, or third party approvals for asset transfers. If the requisite shareholder or board approval is reflected in a binding contract or letter of intent, the specified sale must thereafter be consummated in accordance with the contract or letter of intent and the formal plan of liquidation be adopted as required above.

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[95] As an example, if prior to November 20, 1985, the company had entered a letter of intent specifying that either substantially all the assets of the company will be sold to a particular purchaser or purchasers for a particular price, or that all the stock of the company will be sold to such persons (who may then liquidate the corporation or make a section 338 election), it will generally be considered that the requisite shareholder or board approval of a transaction described in section 337 of prior law occurred if the contract to sell assets was in fact entered and the corporation liquidates in a transaction described in section 337 before 1988. The same transaction could qualify under the transitional rule for an offer to acquire stock if the contract to sell stock were entered into (and the purchaser made a section 338 election with respect to a pre-1988 acquisition date, or liquidated the corporation before 1988).

Second rule

Under a second rule relating to pre-November 20, 1985 action, sales or distributions pursuant to a plan of liquidation (which includes, for purposes of this purpose, a section 338 election) are not affected by the Act if, before November 20, 1985, (i) there was an offer to purchase a majority of the voting stock of the liquidating corporation, or (ii) the board of directors of the liquidating corporation has adopted a resolution approving an acquisition of the company or recommending the approval of an acquisition of the company to the shareholders; provided in each case the sale or distribution is pursuant to or was contemplated by the terms of the offer or resolution, and a complete liquidation occurs (or the section 338 acquisition date, with respect to which a section 338 election is made) before January 1, 1988. The term "liquidating corporation" includes an acquired corporation (and affiliates) with respect to which a section 338 election is made.

Pre-November 20 action

An offer to purchase a majority of the stock of a corporation is intended to include a tender offer or a binding option given by the offeror and enforceable by the offeree. An offer also includes a letter of intent entered into by the purchaser and seller specifying the essential terms of an acquisition. Any binding contract to acquire a corporation presupposes an offer (as well as the approval and acceptance of the required corporation's shareholders or board of directors). Congress did not intend that a nonbinding offer, as to which there has been no implicit or explicit approval by the board of directors or shareholders of the corporation to be acquired, would be within the scope of the transition rule.

"Pursuant to" requirement

For purposes of these transitional rules, in determining whether a sale or distribution is pursuant to or was contemplated as part of a transaction, Congress intended that deemed sales or exchanges pursuant to a timely section 338 election made with respect to a qualified stock purchase will be presumed to be pursuant to and contemplated by the terms of a pre-November 20, 1985 offer or of a board-approved or recommended acquisition that resulted in the purchase. For example, if, prior to November 20, 1985, the board of directors of a corporation adopted a resolution approving the acquisition of that corporation and if, after November 20, 1985, the acquisition occurs and a timely section 338 election is made prior to January 1, 1988 with respect to the acquired company and its affiliates, the deemed sales pursuant to the section 338 election will not be affected by the Act. In addition, if a corporation qualifies for this transitional rule by virtue of a letter of intent or binding contract the acquisition must occur in accordance with the letter or contract.

Congress also intended that distributions, sales or exchanges will generally be considered pursuant to and contemplated by an acquisition transaction if a formal plan of liquidation is adopted within one year after the acquisition is consummated and the distributions, sales or exchanges commence within that time. However, Congress intended that if such actions commence more than one year after the acquisition, a determination whether the distributions, sales or exchanges are pursuant to or were contemplated by the terms of the offer will be determined on the basis of all the facts and circumstances. Such circumstances include, but are not limited to, references to or statements regarding the possibility of a liquidation made in the acquisition documents, proxy material or other correspondence with shareholders, public announcements, or requests for governmental approvals, as well as internal documentation and correspondence with attorneys or others involved in the acquisition.

Third rule

Under the third rule relating to pre-November 20, 1985 action, distributions, sales or exchanges in a liquidation (including a section 338 election) are not affected by the amendments under the Act if, prior to that date, a ruling request was submitted to the Internal Revenue Service with respect to a transaction (which transaction includes or contemplates a transaction described in section 336 or 337 of prior law (including a section 338 election)), and, pursuant to the transaction described in the ruling request, a plan of complete liquidation is adopted (or a sec. 338 election made) and the liquidation is completed (or the section 338 acquisition date occurs) before January 1, 1988.

Related corporations

In applying the foregoing rules, action (as described above) taken by the board of directors or shareholders of a corporation with respect to a subsidiary of such corporation is treated as taken by the board of directors or shareholders of such subsidiary. For example, if the board of directors of a parent corporation adopted a resolution approving the sale of substantially all the assets and subsequent liquidation of the subsidiary, that action will be considered action of the shareholders and board of the subsidiary regardless of how many tiers below the parent the subsidiary may be (so long as the parent has effective control over the subsidiary).

In certain instances involving a group of several tiers of subsidiaries, even though the parent corporation has not formally adopted such a resolution, the action of a lower-tier subsidiary may be considered evidence of implicit action by the parent. For example, in the case of the liquidation of a group of corporations constituting an affiliated group involving sales under prior-law section 337, all distributee members of the group must liquidate within one year. If one member of such group has prior to November 20, 1985, taken board or shareholder action of the type qualifying for transition relief (as described above) and if that member and the other members do liquidate within the required one year period, it was intended that timely approval by the board or shareholders of the parent corporation of the group will generally be presumed. In other situations involving pre-November 20 action by only one member of a group of commonly controlled corporations, whether that action can be attributed to members of the group other than an effectively controlled subsidiary of the acting corporation will be determined on the basis of all the facts and circumstances.

General transitional rules based on pre-August 1, 1986 or pre-January 1, 1987 action

The amendments made by the Act also do not apply to transactions which do not meet the requirements of the general transitional rules based on pre-November 20, 1985 action, but which are described in one or more of the following categories:

(1) a liquidation completed before January 1, 1987;

(2) a deemed liquidation pursuant to a section 338 election where the acquisition date (the first date on which there is a qualified stock purchase under section 338) occurs before January 1, 1987;[96]

(3) a liquidation pursuant to a plan of liquidation adopted before August 1, 1986, that is completed before January 1, 1988;

(4) a liquidation if a majority of the voting stock of the corporation is acquired on or after August 1, 1986, pursuant to a written binding contract in effect before August 1, 1986, and if the liquidation is completed before January 1, 1988;

(5) a liquidation if there was a binding written contract or contracts to acquire substantially all the assets of the corporation in effect before August 1, 1986, and the liquidation is completed before January 1, 1988; and

(6) a deemed liquidation, under section 338, of a corporation for which a qualified stock purchase under section 338 first occurs on or after August 1, 1986, pursuant to a written binding contract in effect before August 1, 1986, provided the section 338 acquisition date occurs before January 1, 1988.

Rules applicable in determining when plan of liquidation adopted

A plan of liquidation is adopted if the plan has been approved by the shareholders (see Treas. Reg. sec. 1.337-2(b)). If a plan of liquidation would have been considered adopted for purposes of commencing the twelve-month period under prior-law section 337, it will be deemed adopted for this purpose.

Rules applicable in determining whether binding contract in effect of August 1, 1986

For purposes of determining whether there was a binding written contract or contracts to sell substantially all of the assets of a corporation before August 1, 1986, the term "substantially all of the assets" shall generally mean 70 percent of the gross fair market value and 90 percent of the net fair market value of the assets. In addition, even though the contract or contracts cover a lesser amount of assets, if such contract or contracts would require shareholder approval under the applicable state law that may require such approval for a sale of substantially all of such corporation's assets, then they will qualify as contracts to sell substantially all the assets and will be considered binding even though shareholder approval has not yet been obtained.

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[96] If the "acquisition date" under section 338 occurs before the relevant transition date, the prior law provision allowing additional stock to be purchased within a year after the section 338 "acquisition date" is also available. Thus, if there is a qualified stock purchase of 80 percent of the stock of a qualified corporation on December 1, 1986, followed by purchase of the remaining 20 percent on February 1, 1987, the nonrecognition percentage for purposes of section 337 of prior law would be 100 percent. See section 338(c)(1) and Prop. Treas. Reg. section 1.338-4T(k)(5).

An acquisition of stock or assets will be considered made pursuant to a binding written contract even though the contract is subject to normal commercial due diligence or similar provisions and the final terms of the actual acquisition may vary pursuant to such provisions.

For purposes of these rules, a liquidation is completed by a required date if it would be considered completed for purposes of section 337 of prior law by that date. For example, there may be a distribution of assets to a qualified liquidating trust (*See, e.g.*, Rev. Rul. 80-150, 1980-1 C.B. 316).

Amendments to provisions relating to nonliquidating distributions

In general, the conforming amendments to section 311 are effective for distributions after July 31, 1986.

Amendments to provisions relating to subchapter S c orporations

The provisions relating to S corporations that were formerly C corporation are generally effective with respect to returns filed pursuant to S elections made after December 31, 1986.[97] Thus, in the case of S corporations whose election was made before January 1, 1987, the prior-law version of section 1374 will apply. For example, if such an S corporation is liquidated after December 31, 1986 and within 3 years of converting from C to S status, new section 1363 and new section 336 will apply (subject to special transition rules for certain closely held corporations) to require the recognition of gain on the liquidation. If there is capital gain of sufficient amount, prior law section 1374 will impose a corporate level tax on that gain in liquidation.

Delayed effective dates for certain closely held corporations

In general

Special delayed effective dates are provided for certain closely held corporations that are limited in size.[98] Corporations eligible for this rule are generally entitled to prior-law treatment with respect to liquidating sales and distributions occurring before January 1, 1989, provided the liquidation is completed before that date. A liquidation will be treated as completed under the same standard that is applied under the general transitional rules. However, this special transitional rule requires the recognition of income on distributions of ordinary income property (appreciated property that would not produce capital gain if disposed of in a taxable transaction) and short-term capital gain property. Thus, the failure of an eligible closely held corporation to complete its liquidation by December 31, 1986, or otherwise to satisfy the general transitional rules, will result in the loss of nonrecognition treatment for the distribution of appreciated ordinary income and short-term capital gain property. It will also require recognition on distributions of installment obligations that are received in exchange for such property. Congress did not intend to require corporate level recognition on distribution of installment obligations that are received in exchange for long-term capital gain property (including section 1231 property the disposition of which would produce long-term capital gain) where the distribution of such obligations would not have caused recognition under prior law sections 337 and 453B(d)(2).

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[97] For purposes of the transition provisions, if a corporation was a C corporation at any time before December 31, 1986, any "S" status of such a corporation prior to its "C" corporation status is disregarded in determining whether under the statute the first taxable year for which the corporation is an S corporation is pursuant to an S election made after December 31, 1986.

[98] See Act section 633(d).

Corporations eligible for this rule may also make an S election prior to January 1, 1989, without becoming subject to the new rules under section 1374 relating to built-in gains except with respect to ordinary income and short-term capital gain property (it is not necessary that such a corporation liquidate prior to January 1, 1989).[99] However, a corporation having a value in excess of $5 million (but not in excess of $10 million), is subject to a phase-out of this relief. Thus, in such circumstances new section 1374 will apply to a portion of the built-in long-term capital gain. Prior law section 1374 will apply to any portion of the built-in long-term capital gains not subject to new section 1374. In addition, to the extent a corporation is eligible for relief under the small corporation rule, a portion of any other long-term capital gain that would be covered by prior law section 1374 (whether or not built-in at the time of conversion) will continue to be covered by that section.

A taxpayer that purchases the stock of a qualified corporation in a qualified stock purchase prior to that date is entitled to apply prior-law rules (modified as in the case of actual liquidations) with respect to an election under section 338, even though in the hands of the acquiring corporation the qualified corporation no longer satisfies the stock holding period requirements and may not satisfy the size or shareholder requirements due to the size or shareholders of the acquiring corporation.[100]

Although the Act repeals section 333, in the case of a liquidating distribution to which section 333 of prior law would apply a shareholder of a qualified corporation electing such treatment is entitled to apply section 333 without any phase-out of shareholder level relief under the Act. However, an increase in shareholder-level gain could result from an increase in corporate earnings and profits resulting from application of the corporate-level phase-out of relief from repeal of *General Utilities*.

Finally, for distributions prior to January 1, 1989, qualifying corporations continue to be eligible for relief under prior-law rules relating to nonliquidating distributions with respect to qualified stock (sec. 311(d)(2)). However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

Requirements for qualification

A corporation is eligible for these special delayed effective dates if it was in existence on August 1, 1986, its value does not exceed

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[99] A technical correction may be needed to clarify that the election need only be made (not become effective) by this date. Such a correction was included in H. Con. Res. 395 as passed by the House and Senate in the 99th Congress.

[100] A technical correction may be needed so that the statute reflects this intent.

$10 million, and more than 50 percent (by value) of the stock[101] in such corporation is owned by ten or fewer individuals who have held such stock for five years or longer (or the life of the corporation, if less than five years).[102] Full relief is available under this rule only if the corporation's value does not exceed $5 million; relief is phased out for corporations with values between $5 million and $10 million. For purposes of this rule, a corporation's value will be the higher of the value on August 1, 1986, or its value as of the date of adoption of a plan of liquidation (or, in the case of a nonliquidating distribution, the date of such distribution).

Aggregation rules similar to those in section 1563 apply for purposes of determining the value of the corporation on the relevant date, except that control is defined as more than 50 percent rather than 80 percent. Thus, the value of a corporation for purposes of this transitional rule includes the value of other corporations that are (or were) members of its controlled group on the relevant date, including corporations that were completely liquidated prior to January 1, 1987. In providing that all members of the same controlled group of corporations are treated as a single corporation for purposes of this rule, however, Congress did not intend to require that all corporations in a controlled group that would qualify for relief be liquidated in order for the liquidation of any one or more corporations in the group to qualify for relief.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $15 million in 1987, $180 million in 1988, $348 million in 1989, $460 million in 1990, and $551 million in 1991.

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[101] See Act section 633(d)(5)(A).

[102] A technical correction may be needed so that the statute reflects the holding period requirement. A similar correction was included in H. Con. Res. 395 as passed by the House and Senate in the 99th Congress.

Congress intended that, where stock passes to an estate, the holding period of the estate includes that of the decedent. Also, it was intended that the "look-through" attribution rules, generally applicable where stock is held by an entity, would not apply in the case of trusts qualifying under section 1361(c)(2)(ii) or (iii) just as they do not apply under the statute in the case of estates. Thus, stock held by such entities, like stock held by an estate, is to be treated as held by a single qualified person, so that the 10 shareholder test will not cease to be satisfied merely because a decedent's stock passes to such a trust. (In the case of other trusts holding stock, it was intended that the "look-through" attribution rules would apply to determine whether more than 10 qualified persons ultimately own stock.) It was also intended that the holding period of a decedent's estate (or a 1361(c)(2)(ii) or (iii) trust) would be tacked with that of a beneficiary who would have been treated as "one person" with the decedent under the applicable attribution rules. Technical corrections may be needed so that the statute reflects such intent.

In the case of indirect ownership attributed through another entity (for example, a corporation or a partnership) Congress did not intend the rules of section 1223 to apply in all cases for purposes of determining the holding period of the qualified person. In such cases, the qualified person's holding period is the lesser of (1) the period during which the entity held the stock in the qualified corporation, or (2) the period during which the qualified person held the interest in the entity. In the case of holdings through tiers of entities, similar rules apply at each level in determining the holding period of intermediate entities. A technical correction may be necessary so that the statute reflects this intent.

H. Allocation of Purchase Price in Certain Sales of Assets (Sec. 641 of the Act and new section 1060 of the Code)[103]

Prior Law

A sale of a going business for a lump-sum amount is viewed as a sale of each individual asset rather than of a single capital asset.[104] Both the buyer and the seller must allocate the purchase price among the assets for tax purposes. An allocation by the seller is necessary to determine the amount and character of the gain or loss, if any, it will recognize on the sale. An allocation by the buyer is necessary to determine its basis in the assets purchased. This allocation of basis will affect the amount of allowable depreciation or amortization deductions and the amount and character of any gain or loss recognized by the buyer on a subsequent sale, and may have other tax consequences.

Although the parties may agree to a specific allocation of the purchase price among the assets and reflect this allocation in the sales contract, the Code has not required such agreement; thus, the contract may simply state the total purchase price. If the parties do make a specific contractual allocation with appropriate regard to value, they generally may not themselves challenge the allocation for tax purposes.[105] In addition, the courts and the Internal Revenue Service generally have accepted a stated allocation with appropriate regard to value, provided the parties have adverse tax interests with respect to the allocation.[106]

In general, a seller has benefitted if a larger portion of the purchase price is allocable to "pure" capital assets, such as goodwill or going concern value, or (to a lesser extent) to section 1231 assets. If the sale is taxable to the seller, allocations to capital assets would result in tax at the lower capital gains rates, while allocations to ordinary income assets such as inventory would result in tax at ordinary income rates. Amounts allocated to section 1231 assets might result in tax at the preferential capital gains rate, but could produce depreciation recapture income under section 1245 or 1250 or income recognition under other provisions of the Code.

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[103] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 632; S. Rep. 99-313, pp. 251-255; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 208-209 (Conference Report).

[104] *Williams* v. *McGowan*, 152 F.2d 570 (2d Cir. 1945).

[105] *See, e.g., Ullman v. Comm'r*, 264 F. 2d 305 (2d Cir. 1959), *Comm'r* v. *Danielson*, 378 F. 2d 771 (3d Cir. 1967) *cert. den.* 389 U.S. 858.

[106] The adversity of the parties' tax interests is deemed to be evidence supporting the validity of the allocation against an Internal Revenue Service challenge. *Compare, Black Industries, Inc.*, 38 TCM 242 (1979) in which the Tax Court concluded that a portion of the price was properly allocable to nondepreciable going concern value even though the parties had specifically allocated all of the price to other assets. The Tax Court observed that the parties did not as a practical matter have adverse tax interests and accordingly, the court was justified in "carefully scrutinizing the merits of the allocation." 38 TCM 242 at 253.

Even if the seller was a liquidating corporation and the sale was governed by section 337, so that no gain or loss was recognized except for recapture and certain other items, the allocation of purchase price could have tax consequences for the seller. The allocation could determine the amount of recapture income recognized and might affect the extent to which other income would be recognized.[107]

A buyer, on the other hand, has generally benefitted from an allocation that results in a higher basis for inventory or other assets that would generate ordinary income if resold; to depreciable tangible assets such as buildings and equipment; or to intangible assets having determinable useful lives, which would be amortizable.

The interests of the buyer and seller have not necessarily been adverse in the case of section 1231 assets, since the allocation might result in capital gain (or nonrecognition of gain under sec. 337) to the seller while according depreciable basis to the buyer. In some circumstances, however, the allocation produced recapture income to the seller. In the case of certain intangibles, the parties' interests also may not be adverse because the seller would recognize gain of the same character and in the same amount whether or not the asset was considered amortizable in the hands of the purchaser. Under prior law, this gain would often be either capital gain, or eligible for nonrecognition under section 337.

If the parties to the sale of a going business fail to make an allocation of the purchase price among the assets of the business that is respected for tax purposes, the purchase price (less cash and cash equivalents) must still be allocated among the non-cash assets in proportion to their respective fair market values on the date of the sale.[108] Fair market value has been defined under one formulation as the price arrived at by a willing buyer and a willing seller, neither being under a compulsion to buy or sell. No single method of valuation is regarded as determinative of value in all circumstances. Three commonly accepted methods are the reproduction cost method, the capitalization of earnings method, and the comparable sales method.

The valuation of goodwill and going concern value has generally been recognized as more difficult than the valuation of tangible assets or certain other types of intangibles. The two most commonly used methods to value goodwill and going concern value have been the residual method and the formula method.[109] Under the residual method, the value of the goodwill and going concern value is the excess of the purchase price of the business over the aggregate fair market values of the tangible assets and the identifiable intangible assets other than goodwill and going concern value. Under the formula method, goodwill and going concern value were valued by capitalizing the excess earning capacity of the tangible assets of the business based upon the performance of the business over some period prior to the valuation date. The excess earning capacity was the excess of the average earnings of the business during this period over an assumed rate of return on the value of its tangible assets.[110] These excess earnings, capitalized at an appropriate discount rate,[111] were deemed to be the value of the unidentified intangibles.

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[107] For example, the allocation could affect the amount of income recognized under the tax benefit doctrine or other judicial exceptions to section 337. It could also affect the amount of LIFO recapture with respect to inventory and the amount of additional inventory gain if the bulk sale exception of section 337 did not apply.

[108] See Treas. Reg. sec. 1.167(a)-5.

[109] As described in A.R.M. 34, 2 C.B. 31 (1920), *superseded by* Rev. Rul. 68-609, 1968-2 C.B. 327.

While the Service recognized a formula method as a permissible method of valuing goodwill and going concern value, it also stated the position that the method was appropriate only where there is no better evidence of the value of these intangibles.[112] The courts appeared reluctant to apply the formula method because of the subjectivity involved in selecting the appropriate rate of return and capitalization rate. In cases where the value of tangible and identifiable intangible assets could be ascertained with reasonable certainty, the courts generally rejected the formula approach in favor of the residual method.[113]

In some cases a taxpayer who purchased a going business at a premium (that is, a price that it determined exceeded the apparent aggregate fair market values of the tangible and intangible assets, including goodwill and going concern value) might take the position that it is entitled to allocate an amount in excess of fair market value to the basis of individual assets. Relying on one interpretation of the judicial and administrative authorities,[114] the taxpayer would separately value each of the acquired assets and allocate the premium among all the assets (other than cash and cash equivalents) in proportion to their relative fair market values in a so-called "second-tier allocation."

Proposed and temporary regulations issued by the Treasury Department under section 338 mandate a residual method of allocation (and prohibit a second-tier allocation) in determining the basis of assets acquired in a qualified stock purchase for which a section 338 election is made or is deemed to have been made, i.e., a stock purchase which is treated as a purchase of assets for tax purposes.[115] Under these regulations, the deemed purchase price of the assets is first reduced by cash and items similar to cash, and is then allocated sequentially to two defined classes of identifiable tangible and intangible assets; any excess is allocated to assets in the nature of goodwill and going concern value. After the reduction for cash items, no amount may be allocated to any asset in the next two classes in excess of its fair market value.[116]

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[110] This assumed rate of return is the rate prevailing on the valuation date in the industry in which the business is classified, adjusted to reflect the risk involved in the particular business.

[111] Here, too, the rate must reflect the riskiness of the particular business.

[112] Rev. Rul. 68-609, supra.

[113] *E.g., Banc One Corp.* v. *Comm'r*, 84 T.C. 476 (1985); *Jack Daniel Distillery* v. *United States*, 379 F.2d 569 (Ct.Cl. 1967); *Black Industries, Inc.* v. *Comm'r*, 38 T.C.M. 242 (1979). *Compare Concord Control Inc.* v. *Commissioner*, 78 T.C. 742 (1982) (in which the Court stated that it was rejecting the residual method of valuation because of the difficulty of ascertaining other fair market values, but nevertheless based its approach on a finding of such values). The residual method is also applied in computing the value of goodwill under generally accepted accounting principles. A.P.B. Opinion Nos. 16 and 17 (November 1, 1970).

[114] Some taxpayers referred to Rev. Rul. 77-456, 1977-2 C. B. 102, although that ruling did not involve a purchase for a price other than the value of all the assets. The ruling involved a purchase price that was stated to represent the fair market value of all the corporate assets at the time of purchase, and addressed only the issue of allocating basis under section 334(b)(2) when there were post-acquisition changes in asset value occurring prior to the liquidation of the acquired target. *See also United States* v. *Cornish*, 348 F.2d 175 (9th Cir. 1965), a case involving the valuation of partnership assets in the context of a sale of partnership interests. The court there found that a "premium" had been paid, but was able to identify the items to which it was attributable—one, the value of certain partners' future services, and the other, the value of an interest element in a deferred purchase price that the law at the time did not require be accounted for as interest. It nevertheless allowed amounts attributable to these items to be allocated to other assets apparently because it concluded that the partners' services were not an "asset" that was purchased, and that it had no mechanism to treat the interest element as interest.

[115] Prop. and Temp. Treas. Reg. sec. 1.338(b)-2T.

Reasons for Change

Congress was aware that the allocation of purchase price among the assets of a going business had been a troublesome area of the tax law. Purchase price allocations had been an endless source of controversy between the Internal Revenue Service and taxpayers, principally because of the difficulty of establishing the value of goodwill and going concern value. The Service lacks the resources to challenge allocations to goodwill or going concern value in all or even a substantial portion of the cases in which it would otherwise assert that the value of those assets are misstated.

Congress believed that it is appropriate to treat the "premium" involved in second-tier allocations as a payment for assets in the nature of goodwill or going concern value, rather than a payment in excess of the total value of the purchased assets. Congress therefore required taxpayers to apply the residual method in allocating basis to goodwill and going concern value in all purchases of a going business. The mandatory application of the residual method is also warranted in view of the difficult and uncertain assumptions that are demanded by the application of the formula method and the excessive amount of conflict generated between taxpayers and the Service concerning its application.

The method adopted by the Act is identical to that provided in the regulations under section 338 for allocating purchase price to assets following a stock purchase. Thus, the Act will not only tend to reduce controversies between the Service and taxpayers, it will also eliminate disparities between asset purchases and stock purchases treated as asset purchases under section 338 insofar as purchase price allocations are concerned.

In adopting the basis allocation rules as prescribed by the section 338 regulations, Congress intended no inference as to the propriety under prior law of methods of allocation in asset acquisitions other than the residual method.

Congress was also concerned about the potential for abuse inherent in the sale of a going business where there is no agreement between the parties as to the value of specific assets. In many instances the parties' allocations for tax reporting purposes have been inconsistent, resulting in a whipsaw of the government. Congress expected that requiring both parties to use the residual method for allocating amounts to nonamortizable goodwill and going concern value may diminish some of this "whipsaw" potential. Congress recognized that the repeal of preferential capital gains rates and of the so-called *General Utilities* doctrine (which allowed nonrecognition of corporate level gain in liquidating sales or distributions) would reduce the number of situations in which the parties might have adverse tax interests. However, in such cases, Congress intended to provide a mechanism to assist the IRS in identifying situations, for example, where an unusually low amount may have been allocated to nondepreciable goodwill and going concern value. Congress authorized the Treasury Department to require reporting by parties to the sale of a business, so that information reporting may be required regarding amounts allocated to goodwill and going concern value and to any other categories of assets or specific assets, and such other information as the Secretary deems necessary or appropriate.

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[116] The proposed and temporary regulations apply to all stock acquisitions occurring after August 31, 1982. However, the Internal Revenue Service has amended the regulations to provide an election for acquisitions occurring before January 30, 1986. A taxpayer making this "transitional allocation election" may allocate basis according to the allocation rules applicable on the acquisition date when a group of assets are acquired for a lump-sum purchase price. See Temp. and Prop. Reg. sec. 1.338(b)-4T (June 27, 1986).

Explanation of Provision

The Act requires that, in the case of any "applicable asset acquisition," both the buyer and the seller must allocate purchase price in the manner prescribed in section 338(b)(5). Thus, both parties must use the residual method as described in the regulations under section 338. *See* Temp. Treas. Reg. sec. 1.338(b)-2T.[117] An applicable asset acquisition is any transfer of assets constituting a business in which the transferee's basis is determined wholly by reference to the purchase price paid for the assets. A transaction may constitute an applicable asset acquisition even though section 1031 (relating to like-kind exchanges) applies to a portion of the assets transferred. Both direct and indirect transfers of a business are intended to be covered by this provision, including, for example, a sale of a business by an individual or a partnership, or a sale of a partnership interest in which the basis of the purchasing partner's proportionate share of the partnership's assets is adjusted to reflect the purchase price.[118] A group of assets will constitute a business for this purpose if their character is such that goodwill or going concern value could under any circumstances attach to such assets. For example, a group of assets that would constitute an active trade or business within the meaning of section 355 will in all events be considered a business for purposes of this provision. Moreover, businesses that are not active businesses under section 355 will also be subject to this rule.

In requiring use of the residual method, the Congress did not intend to restrict in any way the ability of the Internal Revenue Service to challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and to take into account all factors, including any lack of adverse tax interests between the parties. For example, in certain cases it would be reasonable for the Service to make an independent showing of the value of goodwill or going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.

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[117] Congress intended to endorse the use of the residual method and generally to apply the same method regardless of whether the transfer took the form of a stock transfer or an asset transfer. It did not intend to preclude the Treasury Department from making changes to the final regulations, not inconsistent with the statutory purpose.

[118] Thus, Congress intended the residual method to be used in determining the fair market value of partnership assets for purposes of applying the provisions of section 755 of the Code dealing with basis allocation in partnership transactions.

The Act also authorizes the Treasury Department to require information reporting by the parties to an applicable asset acquisition. This may include information regarding amounts allocated to goodwill or going concern value, as well as any other categories of assets or specific assets, and such other information as it deems necessary or appropriate.

Effective Date

The provision is effective for transactions after May 6, 1986, unless pursuant to a binding contract in effect on that date and at all times thereafter.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $58 million in 1987, $57 million in 1988, $67 million in 1989, $76 million in 1990, and $82 million in 1991.

I. Related Party Sales (Sec. 642 of the Act and secs. 453, 707 and 1239 of the Code)[119]

Prior Law

Installment sale treatment is not available for gain on a sale of property to a related party if the property is depreciable in the hands of the transferee, unless it is established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose of the sale. Gain on sales of depreciable property between related parties is treated as ordinary income. In the case of certain related party partnership transactions, ordinary income treatment is also required if the property is not a capital asset in the hands of the transferee.

Under prior law, related parties for these purposes included a person and all entities which are at least 80 percent owned, (or more than 80 percent, for some purposes) directly or indirectly, with respect to that person. Specified attribution rules applied.

Reasons for Change

Congress determined that a more comprehensive definition of related parties was appropriate. In the case of installment sales of depreciable property between related parties, Congress also determined that the so-called "open transaction" cost-recovery method of reporting (see, *Burnet v. Logan* 283 U.S. 404 (1931)) should not be permitted and that the purchaser should not increase its basis in the property by any amount before the seller includes such amount in income.

Explanation of Provision

The Act modifies the definition of the related parties to which the present law rules apply. Under the Act, related parties include a person and all entities more than 50 percent owned, directly or indirectly, by that person. Related parties also include entities more than 50 percent owned, directly or indirectly, by the same persons.[120] The attribution and relationship rules are generally based on present law rules that apply to limit losses on sales between related parties. For example, there is attribution between parents and children.

As under prior law, in the case of an installment sale of depreciable property between related parties, the installment method of reporting may not be used but the seller must include all payments to be received in income in the year of the disposition. Contingent payments must also be included in the seller's income in the year of disposition. The Act requires that in the rare and extraordinary case in which the fair market value of contingent payments may not be reasonably ascertained, basis shall be recovered ratably. The so-called "open transaction" cost-recovery method of reporting sanctioned in *Burnet* v. *Logan*, 283 U.S. 404 (1931) may not be used. Congress intended no inference as to the viability of the cost-recovery method under prior law.

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[119] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 8216-8 (June 24, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 210 (Conference Report).

[120] Congress intended the provisions denying installment sale treatment, as well as the provisons denying capital gains treatment, to apply to transactions between partnerships that have a relationship described in section 707(b)(2)(B). A technical amendment may be needed so that the statute reflects this intent with respect to installment sales.

In addition, in the case of an installment sale of depreciable property between related parties, the purchaser may not increase basis by any amount until the seller has included such amount in income.[121]

The provision applies to sales after October 22, 1986, (the date of the enactment of the Act) unless made pursuant to a binding contract in effect on August 14, 1986 and at all times thereafter.

Revenue Effect

This provision is estimated to increase net fiscal year budget receipts by $4 million in 1987, and by $5 million in each of 1988, 1989, 1990 and 1991.

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[121] This basis provision applies not only to contingent payments as to which the fair market value may not be reasonably ascertained but also to any other amount in an installment sale of depreciable property between related parties. A technical correction may be needed so that the statute reflects this intent. Such a correction was included in H.Con.Res. 395 as passed by the House and Senate in the 99th Congress.

J. Amortizable Bond Premium (Sec. 643 of the Act and sec. 171 of the Code)[122]

Prior Law

Normally a debt instrument is issued for a price that approximates the amount that will be received by the lender at maturity, and the return to the lender is entirely in the form of periodic interest payments. If a debt instrument is issued at a premium, the issue price is more than the amount to be repaid to the lender. Generally, a premium is paid when the stated rate of interest on a debt instrument exceeds prevailing interest rates.

The holder of an instrument acquired at a premium could elect to amortize the premium over the term of the debt instrument. Amortizable bond premium, which was allowed as an ordinary deduction, effectively reduced the stated rate of interest on a debt instrument (by offsetting interest income).

An election to amortize premium was effective for all bonds held or acquired at or after the beginning of the first taxable year for which the election was made.

Reasons for Change

The Congress concluded that the deduction for premium generally should be treated as interest, because premium serves to adjust interest income with respect to a debt instrument.[123] Further, the Congress was concerned that taxpayers could acquire obligations at a premium to generate tax deductions to defer tax liability.

For example, it was understood that taxpayers purchased bonds at a premium in one year, with the first interest payment falling in the following year, and deducted a portion of the premium in the first year against other income. The Congress appreciated that deferring the deduction until the related interest was includible in income would involve administrative complexity. The Congress concluded that treating amortizable bond premium as interest would reduce tax-shelter transactions, because the deduction would be subject to the investment interest limitations.

Explanation of Provision

The Act provides that the deduction for amortizable bond premium is treated as interest, except as otherwise provided by regulations.[124] Thus, for example, bond premium is treated as interest for purposes of applying the investment interest limitations.

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[122] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S8286 (June 24, 1986); and H. Rep. 99-841, Vol. II (September 18, 1986), p. 211.

[123] *See also* sec. 1803 of the Act (which conforms the calculation of bond premium to that of original issue discount, consistent with the treatment of bond premium as interest).

[124] *See also* sec. 132 of the Act (amortizable bond premium is not subject to the two-percent floor applicable to miscellaneous itemized deductions).

Effective date

The provision is effective for obligations acquired after October 22, 1986 (the date of enactment of the Act). For taxpayers who had elections in effect as of October 22, 1986, such elections will apply to obligations issued after that date only if the taxpayer so chooses (in such manner as may be prescibed by the Secretary.[125]

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $2 million in 1986, $3 million in 1988, $3 million in 1989, $3 million in 1990, and $3 million in 1991.

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[125] *See* sec. 1803 of the Act.

K. Certain Entity Not Taxed as a Corporation (Sec. 646 of the Act)[126]

Prior Law

Entities that are organized as trusts under local law may be subject to Federal income tax as corporations, rather than trusts, if they possess certain corporate characteristics. Such entities must pay corporate level tax in addition to the tax at the beneficiary level.

A certain trust (Great Northern Iron Ore Trust) was held to be taxable as a corporation due to the existence of certain business powers.

Reason for Change

Congress believed that a certain trust (Great Northern Iron Ore Trust) should not be taxed as a corporation if specified conditions are satisfied including non-exercise of certain powers contained in its trust instrument.

Explanation of Provision

Under the Act, a certain trust (Great Northern Iron Ore Trust) will not be taxed as a corporation if, among other things, it makes an election and agrees not to exercise business powers contained in its trust instrument.

Effective Date

The provision is effective for taxable years beginning after October 22, 1986 (the date of enactment of the Act) and after the taxable year in which the election is made, provided that all conditions of the Act continue to be satisfied.

Revenue Effect

This provision is estimated to have no significant revenue effect on fiscal year budget receipts.

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[126] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 8216-8218 (June 24, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 249 (Conference Report).

L. Cooperative Housing Corporations (Sec. 644 of the Act and sec. 216 of the Code)[1]

Prior Law

Overview

Under both prior and present law, a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued to the cooperative to the extent such amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative which are paid or incurred by the cooperative with respect to the cooperative's land or buildings, and (2) interest allowable as a deduction to the cooperative, which is paid or incurred by the cooperative with respect to indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, rehabilitation, etc. of the cooperative's buildings (sec. 216(a)). Under prior law, the tenant-stockholder's proportionate share of the cooperative's interest and taxes was that portion of such items that bore the same ratio to the cooperative's total interest and taxes that the portion of the cooperative's stock held by the tenant-stockholder bore to the total outstanding stock of the cooperative (sec. 216(b)(3)).

Under both prior and present law, a cooperative housing corporation generally is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, except on a complete or partial liquidation of the cooperative, and (4) 80 percent or more of the gross income for the taxable year of which is derived from tenant-stockholders. Under prior law, a tenant-stockholder generally was only an individual owning fully paid-up stock in the cooperative corporation, the purchase price of which bore a reasonable relationship to the value of the cooperative's equity in its land and buildings that is attributable to the dwelling unit that the individual is entitled to occupy.

Under prior law, for purposes of the above rules, tenant-stockholders generally were limited to individuals. Thus, corporations, trusts, and other similar entities generally did not qualify as tenant-stockholders under prior law. An exception was provided where a person (including a corporation) sells property or leasehold interests to a cooperative and acquires stock in the cooperative within one year after making such transfer. In such cases, the person selling the property was treated as a tenant-stockholder for a period not exceeding three years from the date of acquisition of the stock. This treatment applied even if, by agreement with the cooperative, such person or its nominee may not occupy the house or apartment without prior approval of the cooperative.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1405; H.Rep. 99-426, pp. 868-870; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1703 and 1704; S.Rep. 99-313, pp. 890-892; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 212-213 (Conference Report).

Also under prior law, a bank or other lending institution that obtained stock in a cooperative housing corporation by foreclosure was treated as a tenant-stockholder for up to three years after the date of acquisition (even if the lending institution or its nominee could not occupy the unit without prior approval of the cooperative).

For purposes of the 80-percent test, stock owned, and dwellings leased by governmental entities for the purpose of providing housing facilities, were not taken into account.

Allowance of depreciation deduction

Under both prior and present law, in addition to deductions for rent, interest, and taxes, to the extent a tenant-stockholder uses depreciable property leased from the cooperative in a trade or business or for production of income, the tenant-stockholder is allowed a deduction with respect to the stock that gives him the right to lease the property. This deduction generally is limited to that portion of the taxpayer's adjusted basis for the stock that is allocable to the depreciable property. Prior and present law provide that the allowance of this deduction is not to be construed to limit or deny a depreciation deduction by the cooperative itself with respect to leased property.

Reasons for Change

Proportionate share rule

The Congress believed that the proportionate share rule pursuant to which a housing cooperative's expenses for interest and taxes are allocated among tenant-stockholders may create inequitable results in at least three situations.

The first situation is where a housing cooperative issues equal numbers of shares to all tenant-stockholders regardless of the relative values of the dwelling that each such tenant-stockholder is entitled to occupy (usually to provide each tenant-stockholder with an equal say in matters of corporate governance), but the periodic charges payable to the cooperative by each of the tenant-stockholders reflect the differing values of, or the differing costs associated with, their respective dwellings. In this case, the proportionate share rule would allocate equal amounts of interest and taxes to each tenant-stockholder notwithstanding the unequal portions thereof borne by such tenant-stockholders.

The second situation is where a tenant-stockholder prepays all or a portion of the housing cooperative's indebtedness allocable to the tenant-stockholder's dwelling unit and the periodic charges payable to the cooperative by such tenant-stockholder are reduced commensurately with the reduction in the cooperative's debt service. Here, the proportionate share rule would not take into account the reduction in the amount of interest paid by the cooperative attributable to that particular tenant-stockholder (which may be zero after a complete prepayment).

The third situation is where the housing cooperative is located in a jurisdiction that separately assesses the dwelling units in a cooperative for real estate tax purposes, and the periodic charges payable by each tenant-stockholder directly reflect such separate assessments. Here, the proportionate share rule would allocate the cooperative's taxes among the tenant-stockholders proportionately with their stockholdings, ignoring the differing portions of such taxes borne by such tenant-stockholders.

The Congress believed that the proportionate share rule may not achieve the proper income tax consequences in these and analogous situations and believed that the rule should be modified to account properly for such situations.

Definition of tenant-stockholder

The Congress believed that the tax treatment of corporations, trusts, and other nonindividual entities that own stock in cooperative housing corporations should be the same as that of individuals. To allow cooperatives to maintain control over occupancy of individual units, the Congress believed that this treatment should apply although the cooperative retains the right to approve any individual who occupies a house or apartment as a nominee of an entity owning stock in the cooperative.

Limitation on depreciation deduction

The Congress believed that a tenant-stockholder should not be able to obtain deductions for the capital costs of his cooperative unit more quickly than if he had owned the unit. Accordingly, in connection with the above change, the Act disallows maintenance and lease deductions by tenant-stockholders in situations where the amounts paid are properly chargeable to the capital account of the cooperative.

Explanation of Provision

Proportionate share rule

Under the Act, where a cooperative housing corporation (the "cooperative") charges each tenant-stockholder with a portion of the cooperative's interest or taxes in a manner that reasonably reflects the cost to the cooperative of the interest and taxes attributable to such tenant-stockholder's dwelling unit, then the cooperative may make an election whereby the share of the cooperative's interest and taxes that each tenant-stockholder is permitted to deduct would be the amounts that were so separately allocated and charged.

The Congress intended that this provision is to be availed of in circumstances that will result in an allocation of the cooperative's interest and taxes that more accurately reflects the relative burdens of such items borne by respective tenant-stockholders. The requirement that the allocation reasonably reflect the cost to the cooperative of the interest and taxes attributable to the tenant-stockholder's dwelling unit is intended to assure that a cooperative may not allocate deductible expenses of the cooperative to those tenant-stockholders for whom the deductions would be most valuable, and the non-deductible expenses of the cooperative to those tenant-stockholders for whom the deductions would be less valuable.

Thus, taxes allocated to a tenant-stockholder's unit will be considered to reasonably reflect the cost of the cooperative if the taxes allocated are based on the amounts separately assessed by the taxing authority. In the case of indebtedness of the cooperative incurred to purchase property, interest allocated to a tenant-stockhoder's unit will be considered to reasonably reflect the cost to the cooperative if the amount allocated is based on the cooperative's purchase price of the property, allocated in accordance with the fair market value of the units purchased (including the unit's share of common areas).

Definition of tenant-stockholder

The Act amends the definition of tenant-stockholder to mean any person (rather than any individual) who satisfies the requirements otherwise applicable to tenant-stockholders. Thus, under the Act, corporations, trusts, estates, partnerships, associations, or companies (as well as individuals) may be tenant-stockholders qualifying for pass-through treatment.

If a person other than an individual acquires stock in a cooperative, there shall not be taken into account, for purposes of determining whether the person is a qualifying tenant-stockholder, the fact that, by agreement with the cooperative, such person's nominee may not occupy the house or apartment without the prior approval of the cooperative. This change enables, for example, a corporation owning stock in the cooperative to qualify for pass-through treatment although the cooperative retains the right to approve any individuals who occupy units under arrangements with the corporation.

The Act further provides that, in the case of an original seller of houses or apartments to a cooperative (including individuals or other entities), there shall not be taken into account the fact that, by agreement with the cooperative, the original seller or its nominee may not occupy a house or apartment without prior approval of the cooperative. This rule applies where the original seller acquires stock not later than one year after transferring houses or apartments (or leaseholds therein) to the cooperative.

Also under the Act, where any person acquires stock of a cooperative housing corporation by operation of law (including acquisition by inheritance or foreclosure), for purposes of determining whether such person is a qualifying tenant-stockholder, there shall not be taken into account the fact that, by agreement with the cooperative, such person or his nominee may not occupy the house or apartment without prior approval of the cooperative.

The prior-law rules regarding original sellers and foreclosures by lending institutions are made unnecessary by these changes and, therefore, are repealed.

Limitation on depreciation deduction

Under the Act, a tenant-stockholder using his unit as depreciable property in a trade or business or for the production of income is allowed a deduction as under present law to the extent of that portion of his adjusted basis for his stock that is allocable to such depreciable property. The Act further allows deductions exceeding this basis to be carried over to succeeding taxable years. However, the Act provides that no deduction may be allowed to a tenant-stockholder for any amount paid or accrued to the cooperative (in excess of the tenant-stockholder's proportionate share of interest and real estate taxes) to the extent that, under regulations issued by the Secretary of the Treasury, such amount is properly allocable to amounts chargeable to the cooperative's capital account. Any deduction disallowed under this rule will be applied to increase the stockholder's adjusted basis for his stock. This rule generally prevents a tenant-stockholder (including a corporation) from obtaining deductions for the capital costs of his cooperative unit more quickly than if he had owned the unit.

Effective Date

The provisions of the Act relating to the proportionate share rule, the definition of a tenant-stockholder, and the limitation on the depreciation deduction are effective for taxable years beginning after December 31, 1986. Special rules are provided for two specified limited-profit housing cooperatives relating to the treatment of specified loan refinancings, the treatment of income earned on the reserve fund of such cooperatives in taxable years beginning prior to January 1, 1986, and the treatment of payments made from the respective reserve funds in taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by less than $5 million annually.

M. Definition of Personal Holding Company Income (Sec. 645 of the Act and secs. 543 and 553 of the Code) [3]

Prior Law

Personal holding companies

Under both prior and present law, a corporation that is treated as a personal holding company is subject, in addition to the regular corporate tax, to a 50-percent tax on its undistributed personal holding company income for the taxable year. Generally, a personal holding company is a corporation at least 50 percent of the value of the stock of which is held by not more than five individuals, and at least 60 percent of the adjusted ordinary gross income of which is personal holding company income (sec. 542(b)). For the purpose of the stock ownership test, an individual is treated as owning the stock owned directly or indirectly by or for any family members or partners of the individual and also is treated as owning a proportionate share of stock owned by corporations or partnerships in which the individual is a stockholder or partner (sec. 544).

Personal holding company income generally includes passive-type income such as interest, dividends, and certain rents and royalties (sec. 543(a)). Exceptions are provided for certain rents and royalties where the corporation derives most of its income from such rents or royalties, has only limited amounts of other personal holding company income (or distributes most of such income), and incurs deductible expenses in amounts that reflect active business activity rather than the mere collection of passive income. Under prior law, royalties relating to the use of computer software are not eligible for any of such exceptions.

Certain corporations are excepted from the definition of personal holding company. The excepted corporations include tax-exempt organizations, banks, domestic building and loan associations, life insurance companies, surety companies, foreign personal holding companies, lending or finance companies that meet certain active business or gross income tests, foreign corporations with no U.S. shareholders, small business investment companies licensed by the Small Business Administration, and corporations subject to the jurisdiction of the Bankruptcy Court (sec. 542(c)).

Foreign personal holding companies

In general, under both prior and present law, the undistributed foreign personal holding company income of a foreign personal holding company is treated as having been distributed as a dividend on the last day of the corporation's taxable year and is included in the income of certain U.S. shareholders (sec. 551). In general, under prior and present law, a foreign personal holding company is a corporation at least 60 percent of the gross income of which is foreign personal holding company income, and that meets a specific stock ownership requirement. Under prior law, the stock ownership requirement was met if more than 50 percent (in value) of the stock of which was owned at any time during the taxable year directly or indirectly by or for not more than five individuals who are citizens or residents of the United States (sec. 552).[3]

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[3] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1406; H.Rep. 99-426, pp. 870-875; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1302; S.Rep. 99-313, pp. 708-711; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 247-248 (Conference Report).

Undistributed foreign personal holding company income generally is the corporation's taxable income with certain adjustments, less the deduction for dividends paid (sec. 556). Under prior law, foreign personal holding company income included royalties without any exception for any royalties related to computer software (sec. 553).

Reasons for Change

Since the prior-law rules defining personal holding company income make no exceptions for any royalty income derived from the licensing of computer software, it is possible that a closely held corporation that is engaged in extensive business activities relating to the development and distribution of computer software could have been subject to the personal holding company tax or the foreign personal holding company provisions unless it distributes its income to shareholders. The Congress believed that it is inappropriate to apply the personal holding company tax or the foreign personal holding company provisions in this situation, and that an exception to the definition of personal holding company income and foreign personal holding company income analogous to those provided for rent and certain other types of royalties for purposes of the personal holding company tax should be provided.

Explanation of Provisions

Overview

Under the Act, certain royalties relating to computer software are not treated as personal holding company income or foreign personal holding company income. To qualify for this treatment, the recipient must (a) be actively engaged in the trade or business of producing, developing, or manufacturing computer software, (b) derive more than half of its income from software royalties, (c) incur substantial trade or business expenses, or research and development expenses, in such trade or business, and (d) distribute most of its passive income other than software royalties.

Active business requirements

Under the Act, personal holding company income or foreign personal holding company income does not include certain computer software royalties. To qualify for the exception, four conditions must be met.

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[3] Under section 1222 of the Act, a corporation would be treated as a foreign personal holding company if either more than 50 percent of its stock, in value *or* voting power, was held by the requisite number of shareholders, and if the other applicable requirements were met.

First, computer software royalties must be received by a corporation engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software; such computer software (a) must be developed, manufactured, or produced by such corporation (or its predecessor) in connection with such trade or business, or (b) must be directly related to such trade or business (the trade or business test). For this purpose, a predecessor includes a partnership the partners of which developed the computer software for the partnership and transferred their partnership interests to the corporation in exchange for substantially all of the corporation's stock.

Second, computer software royalties that meet the first requirement must make up at least 50 percent of the ordinary gross income (as defined in sec. 543(b)) of the taxpayer for the taxable year (the "50-percent test").

Third, the amount of expenses that are properly allocable to the active business of developing, producing, or manufacturing computer software and that are allowable to the taxpayer under section 162 (relating to trade or business expenses), section 174 (relating to research and development expenses), or section 195 (relating to amortization of start-up expenses), must equal or exceed 25 percent of the ordinary gross income of the taxpayer for the taxable year (the "25-percent test").[4] Alternatively, the average of such deductions for the period of five taxable years ending with the current taxable year (or such shorter period as the corporation may have been in existence) must equal or exceed 25 percent of the ordinary gross income of the taxpayer for such period.

In computing deductions under section 162, the taxpayer may not take into account payments for personal services rendered by the five shareholders holding the largest percentage (by value) of the outstanding stock of the corporation. In determining the five largest shareholders for this purpose, stock deemed to be owned by a shareholder solely by reason of attribution from a partner (under sec. 544(a)(2)) is not taken into account, and individuals holding less than five percent of the corporation's stock (by value) are not taken into account.

Fourth, the sum of dividends paid during the taxable year (under sec. 562), dividends considered paid on the last day of the taxable year (under sec. 563), and the consent dividends for the taxable year (under sec. 565) must equal or exceed the amount of the corporation's personal holding company income in excess of 10 percent of the ordinary gross income of the corporation. For purposes of this computation, however, personal holding company income does not include the computer software royalties taken into account for the 50-percent test, and also does not include interest income for the five-year period beginning with the commencement of the active computer software business, provided that the 50-percent test and the 25-percent test also are met in this period.

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[4] For purposes of this computation, any deduction specifically allowable under any section of the Code other than section 162 may not be treated as allowable under section 162.

Special rule for affiliated groups

Under the Act, a special rule is provided in the case of computer software royalty income received by a member of an affiliated group. The Act provides that, if a taxpayer who is a member of an affiliated group (within the meaning of sec. 1504(a)) receives royalties in connection with the licensing of computer software and another member of the group meets the trade or business test, the 50-percent test, and the 25-percent test with respect to such software, then the taxpayer is treated as having met such requirements.

Effective Date

The provision is effective for royalties received before, on, or after December 31, 1986. The Act does not allow taxpayers to reopen any taxable years closed by the statute of limitations to claim refunds based on the provision. Certain interest income of a specified broker-dealer in securities is not treated as personal holding company income, effective for interest received on or after the date of enactment (October 22, 1986). Rules similar to those for computer software royalties are provided for royalties derived by a specified toy manufacturer from the licensing of toys, effective for royalties received or accrued in taxable years beginning after December 31, 1981. In addition, the Act excludes from the definition of passive investment income for purposes of subchapter S of the Code, computer software royalties derived by a specified taxpayer, which royalties would not be treated as personal holding company income under the Act, effective for taxable years beginning after December 31, 1984.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $40 million in 1987, $10 million in 1988, $9 million in 1989, $7 million in 1990, and $6 million in 1991.

N. Regulated Investment Companies (Secs. 651-657 of the Act and secs. 562, 851-855, 4982, and 7609 of the Code) [5]

Prior Law

In general, under prior and present law, a regulated investment company ("RIC") is an electing domestic corporation that either meets or is excepted from certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified sources commonly considered passive investment income (sec. 851(b)(2)), that has a portfolio of investments that meet certain diversification requirements (secs. 851(b)(4) and 851(e)), that distributes at least 90 percent of its net income to its shareholders annually (sec. 852(a)(1)), and that also meets certain other requirements (secs. 851, 852). Among these other requirements, less than 30 percent of its gross income must be derived from gains from the sale of securities held for less than three months (sec. 851(b)(3)). A RIC generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders. Thus, a RIC is treated, in essence, as a conduit for Federal income tax purposes. A RIC does not receive a deduction with respect to dividends paid unless the distribution is pro rata with respect to other shares of the same class (sec. 562(c)).

Under prior and present law, RICs are permitted to adopt taxable years other than a calendar year. If a RIC declares a dividend prior to the time that it is required to file its tax return for a taxable year and the dividends are distributed within 12 months following the close of the taxable year (but not later than the date of the first regular dividend payment made after the declaration date), such dividends may be treated for purposes of the RIC's dividends paid deduction as having been paid in that taxable year (sec. 855(a)). Such dividends (commonly called "spillover dividends") are treated as having been received by shareholders in the year of distribution (sec. 855(b)).

A RIC that has long-term capital gain income may designate a dividend as a capital gain dividend in a notice sent to shareholders within 45 days after the end of its taxable year (sec. 852(b)(3)). Shareholders treat such capital gain dividends as long-term capital gain regardless of their holding period of the RIC stock, and the RIC is not required to pay any capital gains tax on the amount so designated.

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[5] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 633; S.Rep. 99-313, pp. 260-262; Senate floor amendment, 132 Cong. Rec. S8206-S8207 (June 24, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 242-246 (Conference Report).

Under prior law, if a RIC, organized as a corporation, had several "series" of stock, with each series of stock representing an interest in the income and assets of a particular fund, the RIC generally was treated as a single corporation.[6] Under prior law, if the RIC was organized as a business trust, it was unclear whether the RIC properly was treated as a single corporation or whether each fund properly is treated as a separate corporation.

Under prior and present law, in the case of certain summonses served upon "third party recordkeepers," certain notice requirements are imposed on the Internal Revenue Service (sec. 7609). Under prior law, third party recordkeepers generally include various types of financial institutions, and others such as attorneys, accountants, and brokers, but do not include RICs. Under prior law, corporations electing to be treated as business development companies under the Investment Company Act of 1940 were not eligible to be RICs.

Reasons for Change

Imposition of excise tax

In the case either of a RIC that has a taxable year other than a calendar year or a RIC that distributes dividends after the close of its taxable year but elects to have the dividends treated as having been paid in the previous taxable year under section 855, significant opportunity is available for deferring recognition of currently earned income by the RIC shareholders. For example, a RIC that has a taxable year ending on January 31, earns $120 ratably throughout its taxable year ending January 31, 1986. The RIC distributes $120 of dividends on January 28, 1986. If the RIC's shareholders are individuals who are calendar year taxpayers, the shareholders would include no amounts in income in their taxable years ending December 31, 1985, and would include $120 in income in their taxable year ending December 31, 1986. The same result is reached if the RIC is a calendar year taxpayer, but pays dividends after the close of the taxable year that it elects to treat as being paid in the prior taxable year (i.e., spillover dividends). As a result, in either situation, no tax is paid either by the RIC or by its shareholders in 1985 on amounts that the RIC may have earned in 1985.

The Congress believed that the deferral of income described above is inconsistent with the conduit treatment that is afforded to RICs. The fundamental premise of conduit treatment is that the RIC's income should be taxed only once at the level of the RIC shareholders, rather than to the RIC. Nevertheless, in either of the cases described above, a substantial portion of the RIC's income may go entirely untaxed in a taxable year. Accordingly, the Congress believed that the ability of RICs to achieve deferral of income for shareholders without penalty should be limited.

The Congress believed that, in general, the mechanism for doing so should be the imposition of an excise tax on those distributions that have the effect of deferring income to the shareholders. In order to assure that the distributions are made promptly, the Congress believed that the rate of the excise tax should be set at a level that would be considered to be more than a mere interest charge on the deferral of tax liability, but would be in the nature of a penalty so that RICs would make significant efforts to distribute income promptly and avoid the imposition of the excise tax. The Congress recognized, however, that the due to the heavy volume of transactions that may be undertaken by RICs, it would not be possible, as a practical matter, to accurately determine and timely distribute the precise amounts necessary to eliminate all deferral achieved by RICs. Consequently, the Congress believed that *de minimis* rules should be provided.

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[6] *See Union Trusteed Funds* v. *Commissioner*, 8 T.C. 1133 (1947), *acq.* 1947-2 C.B. 4; Rev. Rul. 56-246, 1956-1 C.B. 316.

Hedging exception

The Congress believed that the requirement that a RIC derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than three months is an appropriate requirement to ensure that a RIC is a passive entity that is appropriately granted pass-through status. Nevertheless, the Congress recognized that this requirement may not necessarily reflect accurately the extent of the active business activities of a RIC where the RIC engages in certain hedging transactions that are otherwise consistent with the passive nature of the RIC. The Congress believed that, in general, in the case of such hedging transactions, both the hedged and the hedging positions properly are considered to be single investment for purposes of applying the 30-percent test.

Other

The Congress believed that is was appropriate to change the definition of securities for purposes of the qualification tests relating to the income that a RIC is permitted to derive. The Congress understood that the definition of securities as is currently used for purposes of the Investment Company Act of 1940 generally represents that type of passive investment appropriate for a RIC, and hence Congress believed that such definition generally is appropriate for this purpose. In addition, the Congress believed that income derived by a RIC from investments in foreign currency related to the RIC's business of investing in securities also should be treated as qualifying income.

The Congress also believed that it was appropriate to resolve uncertainties and inconsistencies in the treatment of series funds. The Congress believed that each such series functions as a separate RIC and, accordingly, the qualification tests for RIC status should be applied separately to each series.

The Congress believed that preferential dividends that reflect only savings in administrative costs attributable to the size of a shareholder's holdings (and not differences in investment advisory fees) are not the type of preferential dividends that were intended not to qualify for the dividends paid deduction. The Congress believed that such preference dividends should be allowed only in cases where the shareholder who receives the preferential dividend was required to make an initial investment of at least $10 million.

The Congress believed that the period for filing the various notices required for a RIC should be extended from 45 to 60 days. The

Congress also believed that RICs are properly treated as third party recordkeepers. In addition, the Congress believed that corporations electing to be treated as business development companies under the Investment Company Act of 1940 should be eligible to qualify for RIC status.

Explanation of Provisions

Imposition of excise tax

In general

The Act imposes a nondeductible excise tax for any calendar year on any RIC equal to four percent of the excess, if any, of the "required distribution" for the calendar year over the "distributed amount" for such calendar year. The excise tax imposed for any calendar year is to be paid not later than March 15 of the succeeding calendar year.

For these purposes, the term required distribution means, with respect to any calendar year, the sum of (1) 97 percent of the RIC's "ordinary income" for such taxable year, (2) 90 percent of the RIC's capital gain net income (within the meaning of sec. 1222(9)) for the one year period ending on October 31 of such taxable year (as if the one year period ending on October 31 were the RIC's taxable year),[7] and (3) the excess, if any, of the "grossed up required distribution" for the preceding calendar year over the distributed amount for such preceding calendar year. For this purpose, the term "grossed up required distribution" for any calendar year is the sum of the taxable income of the RIC for the calendar year (determined without regard to the deduction for dividends paid) and all amounts from earlier years that are not treated as having been distributed under the provision.

The RIC's ordinary income for this purpose means its investment company taxable income (as defined in sec. 852(b)(2)) determined (1) by taking into account the net capital gain of the RIC and without taking into account the dividends paid deduction, (2) by not taking into account any gain or loss from the sale of any capital asset, and (3) by treating the calendar year as the RIC's taxable year.

In addition, for these purposes, the term "distributed amount" means, with respect to any calendar year, the sum of (1) the deduction for dividends paid (within the meaning of sec. 561) during such calendar year, (2) amounts on which the RIC is required to pay corporate tax, and (3) the excess (if any) of the distributed amount for the preceding taxable year over the required distribution for such preceding taxable year. The amount of dividends paid for these purposes is determined without regard to the provisions of section 855 and without regard to any exempt-interest dividend (as defined in sec. 852(b)(5)).

Under the Act, for purposes of applying these provisions, any deficiency dividend (as defined in sec. 860(f)) is taken into account at the time it is paid, and any income giving rise to the adjustment is treated as arising at the time the dividend is paid.

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[7] The Congress understood that in applying this rule, the period ending October 31, of each calendar year would be treated as the taxpayer's taxable year for purposes of the capital loss carryover provisions and for purposes of the year-end straddle and mark-to-market rules.

Although the excise tax is imposed only for calendar years beginning after December 31, 1986, the computations that are necessary to determine whether any excise tax is due and the amount so due, will require certain calculations involving income, losses,and distributions with respect to periods before the first calendar year for which the excise tax is imposed. For example, the excise tax for the first calendar year beginning after December 31, 1986, generally must take into account capital gains and losses for the period beginning on November 1, 1986, and ending on October 31, 1987. In addition, in computing the excise tax for the first calendar year beginning after December 31, 1986, computation of the grossed up required distribution and distributed amount for the calendar year ending on December 31, 1986 is required.[8]

Special rule for certain regulated investment companies

The Act provides that RICs that have a taxable year ending on either November 30, or December 31, may make an irrevocable election to use their actual taxable year, rather than a year ending on October 31, for purposes of applying the distribution requirement rules relating to capital gains.

Timing of inclusion of certain dividends

The Act provides that any dividend declared by a RIC in December of any calendar year and payable to shareholders of record as of a specified date in such month, shall be deemed to have been paid by the RIC (including for purposes of sec. 561), and to have been received by each shareholder, on such record date, but only if such dividend is actually paid by the RIC before February 1 of the following calendar year. This provision does not apply for purposes of section 855(a), however.[9]

Earnings and profits

Under the Act, a RIC is treated as having sufficient earnings and profits to treat as a dividend any distribution during any calendar year which distribution is treated as a dividend by such RIC (other than a redemption to which sec. 302(a) applies), but only to the extent that the amount distributed during such calendar year does not exceed the required distribution for such calendar year. The purpose of this provision is to prevent a RIC from failing to meet the requirements for avoiding the imposition of the excise tax where losses incurred by the RIC after October 31, but before the close of its taxable year, otherwise would prevent the RIC from having sufficient earnings and profits for its distributions to be treated as dividends.

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[8] Although the statutory definition of the grossed up required distribution seems to require computations of a RIC's income and distributions beginning with the commencement of the RIC's existence, it is anticipated that RICs will be able to derive the proper grossed up required distribution without taking into account periods prior to the first taxable year of the RIC ending before January 1, 1987. In general, after taking into account the spillover dividend, all income for all taxable years ending before January 1, 1987, would either have been distributed to shareholders or taxed to the RIC, and thus would be treated as distributed amounts under section 4982(c). In calculating these amounts, the Congress intended that proper adjustments will be made for periods in which the corporation did not qualify as a RIC.

[9] Thus, a RIC that has a taxable year ending on November 30, may treat such dividends as having been paid prior to December under section 855(a).

Treatment of certain capital losses

For purposes of determining the amount of capital gain dividends that a RIC may distribute for a taxable year, the RIC's net capital gain for the taxable year is determined without regard to any net capital loss attributable to transactions after October 31 of such year. For these purposes, any such net capital loss is treated as arising on the first day of the next taxable year. To the extent provided in Treasury regulations, the same rule will apply for purposes of determining the RIC's taxable income.[10]

Example

For example, assume that a RIC with a taxable year ending June 30, (a) has ordinary income of $100 for the period beginning July 1, 1986 and ending December 31, 1986, (b) has capital gain net income of $50 for the period beginning July 1, 1986, and ending October 31, 1986, (c) has capital gain income of $30 for the period beginning November 1, 1986, and ending December 31, 1987, (d) distributes a spillover dividend with respect to its taxable year ending June 30, 1986, on December 15, 1986, (e) has ordinary income of $500 for the 1987 calendar year, and (f) has capital gain net income of $200 for the period beginning January 1, 1987, and ending October 31, 1987.

In these circumstances, the spillover dividend with respect to the RIC's taxable year ending June 30, 1986, and all other income and distributions with respect to taxable years ending before January 1, 1987, are ignored for purposes of calculating the RIC's required distribution for calendar year 1987. The RIC's required distribution for 1987 will be $842. This consists of the following amounts: 100% of the $100 of ordinary income for the period between July 1, 1986, and December 31, 1986, and the $50 of net capital gain income for the period between July 1, 1986 and October 31, 1986, (these amounts are treated as a prior year shortfall under sec. 4982(b)(2)); 90% of the $230 net capital gain for the period between November 1, 1986, and October 31, 1987; and 97% of the $500 of ordinary income for the 1987 calendar year.

Also, for example, assume that a calendar year RIC (a) has ordinary income of $100 for the 1986 calendar year, (b) has capital gain net income of $50 for the 1986 calendar year, $10 of which is attributable to the period after October 31, 1986, (c) has ordinary income of $100 for the 1987 calendar year, (d) has capital gain net income of $30 for the period beginning January 1, 1987, and ending October 31, 1987, and (e) distributes a spillover dividend with respect to the 1986 calendar year on March 1, 1987.

In these circumstances, except for the $10 of capital gain net income earned after October 31, 1986, and the $10 portion of the spillover dividend attributable to this income, all income and distributions with respect to taxable years ending before January 1, 1987, are ignored for purposes of calculating the RIC's excise tax liability under section 4982. The required distribution for 1987 is $133. This consists of 97% of the $100 of ordinary income for the

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[10] The Congress intended that any such regulations would prevent avoidance of tax, particularly in circumstances where a RIC takes advantage of the rule in order to pay return of capital dividends in the following taxable year, or to offset the tax that would be incurred on capital gains recognized in the following year.

1987 calendar year and 90% of the $40 capital gain net income for the period between November 1, 1986, and October 31, 1987. The $10 portion of the spillover dividend attributable to the RIC's capital gain net income for the period between November 1, 1986, and December 31, 1986 is treated as a distributed amount in 1987.

Hedging exception

The Act modifies the computation of gross income of a RIC for purposes of the requirement of section 851(b)(3) that less than 30 percent of the gross income of the RIC is derived from the sale or exchange of stock or securities held for less than three months.[11] Under the Act, for purposes of applying this test, any increase in value on a position that is part of a designated hedge is offset by any decrease in value (whether or not realized) on any other position that is part of such hedge. For this purpose, increases and decreases in value are taken into account only to the extent attributable to increases or decreases in value (as the case may be) during the period of the hedge. This rule applies for purposes of calculating both gains from the sale or other disposition of stock or securities held for less than three months and also the gross income of the RIC for purposes of section 851(b)(3).

For these purposes, there is a designated hedge where the taxpayer's risk of loss with respect to any position in property is reduced by reason of (1) the taxpayer having an option to sell, being under a contractual obligation to sell, or having made (and not closed) a short sale of substantially identical property, (2) the taxpayer being the grantor of an option to buy substantially identical property, or (3) under regulations prescribed by the Secretary of the Treasury, the taxpayer holding one or more other offsetting positions. The Congress intended that a qualified covered call (within the meaning of sec. 1092(c)) may be treated as part of a designated hedge. In addition, the positions that are part of the hedge must be clearly identified by the taxpayer in the manner prescribed by Treasury regulations.

Prior to the issuance of such Treasury regulations, the Congress intended that the identification requirement would be treated as having been satisfied with identification by the close of the day on which the hedge is established either (a) by the placing of the positions that are part of hedge in a separate account that is maintained by a broker, futures commission merchant, custodian or similar person, and that is designated as a hedging account, provided that such person maintaining such account makes notations identifying the hedged and hedging positions and the date on which the hedge is established, or (b) by the designation by such a broker, merchant, custodian or similar person, of such positions as a hedge for purposes of these provisions, provided that the RIC is provided with a written confirmation stating the date the hedge is established and identifying the hedged and hedging positions.

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[11] The Congress intended that the definition of securities for this purpose would have the same meaning as the definition of securities as clarified for purposes of section 851(b)(2). A technical correction may be necessary to reflect this intention.

Business development companies

The Act provides that a corporation electing to be treated as a business development company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2) may qualify as a RIC.

Preference dividends

The Act provides that differences in the rate of dividends paid to shareholders are not treated as preferential dividends (within the meaning of sec. 562(c)) where the differences reflect savings in administrative costs (but not differences in management fees), provided that such dividends are paid by a RIC to shareholders who have made initial investments of at least $10 million.

Definition of "securities"

The Act provides a definition of "securities" in section 851(b)(2) by reference to the definition of securities in the Investment Company Act of 1940 and includes in qualifying income certain income derived with respect to the RIC's business of investing in securities. Nevertheless, the Congress did not intend that a RIC's distributive share of income from a partnership interest would be treated as qualifying income derived with respect to the RIC's business of investing in securities without regard to the character of the income derived from the partnership.[12] In addition, permitted income for RICs is defined to include income from foreign currencies, and options and futures contracts, derived with respect to the RIC's business of investing. The Act provides regulatory authority to the Treasury Department, however, to exclude gains from investment in foreign currency where such gains are not ancillary to the company's principal business of investing in stock or securities.

Treatment of "series funds"

The Act also provides that, in the case of RICs that have so-called series funds, each fund is treated as a separate corporation. Tax-free treatment is provided for the deemed formation of the separate corporations that are deemed to be formed under the provision.

Time for filing certain notices

The Act extends the time for filing notices for capital gain dividends and certain other purposes from 45 to 60 days.

Third party recordkeeper provisions

RICs are treated as third party recordkeepers under the Act.

Effective Date

The provisions of the Act relating to the imposition of the excise tax on RICs are applicable for calendar years beginning after December 31, 1986. The provision of the Act relating to treatment of a RIC as a third party recordkeeper is effective for summonses served after the date of enactment (October 22, 1986). The provisions relating to preferential dividends are effective for dividends distributed after the date of enactment (October 22, 1986). The other provisions of the Act are effective for taxable years of RICs beginning after the date of enactment (October 22, 1986).

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[12] A technical correction may be necessary to reflect this intention.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $547 million in 1987, $915 million in 1988, $176 million in 1989, $195 million in 1990, and $210 million in 1991.

O. Real Estate Investment Trusts (Secs. 661-669 of the Act and secs. 856-859, 4981, and 6697 of the Code)[13]

Prior Law

Overview

In general, under present and prior law, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property. Thus, the REIT may serve as a means whereby numerous small investors can have a practical opportunity to invest in a diversified portfolio of real estate assets and have the benefit of professional management.

In order to qualify as a REIT and thereby receive conduit treatment, an entity must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Taxation of REITs

Overview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts (sec. 857). REITTI is the taxable income of the REIT with certain adjustments (sec. 857(b)(2)). The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes. Other adjustments to taxable income that are made in arriving at

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[13] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1431-1438; S.Rep. 99-313, pp. 769-782; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 214-221 (Conference Report).

REITTI are (a) the corporate dividends received deduction is not allowed, (b) adjustments attributable to a change in accounting period are not taken into account, (c) net income from foreclosure property (described below) is excluded,[14] (d) net income (or loss) from prohibited transactions (described below) is excluded (or added), and (e) the amount of tax payable on account of unintentional failure to satisfy the income requirements is deducted.

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the alternative capital gains tax regime generally applicable to corporations (sec. 857(b)(3)). However, the REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders (sec. 857(b)(3)(C)). A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Under prior law, the notice was required to be mailed within 30 days after the end of the taxable year in which the dividend is paid. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of their holding period of the stock (sec. 857(b)(3)(C)).

Under prior law, the amount of dividends that a REIT could designate as capital gain dividends could not exceed its REITTI for the taxable year (determined without regard to the dividends paid deduction) (sec. 857(b)(3)(C)). The practical effect of this limitation is that any net operating losses of the REIT would offset the amount of income eligible for capital gain treatment. Such offsetting is the normal rule for corporations that have both capital gains and net operating losses. However, this offsetting resulted in less income receiving capital gains treatment than would be the case if an individual had both capital gains and net operating losses.

Income from foreclosure property

Under prior and present law, in adition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property (sec. 857(b)(4)). Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75 percent income test described below) over all allowable deductions directly connected with the production of such income (*id.*).

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property), such property was not held by the REIT for sale to customers (sec. 856(e)). Limitations are imposed on the period of time that property may be considered to be foreclosure property, and on the ability of REITs to operate foreclosure property other than through an independent contractor.

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[14] The amount of the dividends paid deduction is computed without regard to the the amount of dividends attributable to such income, however.

Income or loss from prohibited transactions

In general, under prior and present law, a REIT must be an entity that is not engaged in any active trade or business and that derives its income from passive sources. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. Under prior law, net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses and other deductions that are directly connected with the sale or other disposition of such property. Under prior law, a safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (sec. 857(b)(6)(C)).

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). Under prior law, the beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership held by 100 or more persons (*id.*).[15] In addition, the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income (*id.*).[16]

Income requirements

Overview

Under prior law, to meet the income requirements, at least 75 percent of the entity's income (excluding gross income from prohibited transactions) must be from rents from real property, interest on obligations secured by mortgages on real property or on interests in real property,[17] gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property), dividends or distributions from another REIT, gain from the disposition of interests in a REIT,[18] abatement or refunds of taxes on real property, and income or gain with respect to property that qualifies as foreclosure property (sec. 856(c)(3)(C)).

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[15] This requirement is considered to be met if it is satisfied for 335 days out of a 12 month taxable year or a proportionate part of a shorter taxable year.

[16] A corporation at least 50 percent of whose stock is held directly or indirectly by or for five or fewer individuals at any time during the last half of its taxable year is treated as a personal holding company if at least 60 percent of its ordinary adjusted gross income for the taxable year comprises personal holding company income (sec. 542). The entity is required to keep records for the purpose of determining actual ownership of interests in the entity for this purpose. *See* Treas. Reg. sec. 1.857-8.

[17] Commitment fees relating to an agreement to make loans which would be secured by real property also are treated as qualifying income.

In addition, under prior and present law, at least 95 percent of the entity's gross income (excluding gross income from prohibited transactions) must be derived from the sources qualifying for the 75 percent test or from other interest, dividends, or gains from the sale of stock or securities (sec. 856(c)(2)). Less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than the applicable holding period for long-term capital gain or loss treatment,[19] real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of sec. 1033), and property that is sold or disposed of in a prohibited transaction (sec. 856(c)(4)).

Definition of rents

In general.—For purposes of the income requirements, under prior law, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease (sec. 856(d)(1)).[20]

Under prior law, amounts are not treated as rents from real property, however, if the amount of such rent is determined in whole or in part based on the net income or profits derived by any person from the use of such property (sec. 856(d)(2)(A)). Rents based on a fixed percentage of gross receipts or sales do not violate this requirement, however.[21] In addition, amounts are not treated as qualifying rent if received from certain parties in which the lessor has an interest of 10 percent or more (sec. 856(d)(2)(B)). Further, where the entity furnishes or renders services to the tenants of rented property, amounts received or accrued with respect to such property are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT, and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT (sec. 856(d)(3)).

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[18] Gains on the sale of interests in a REIT would not qualify if such interests were treated as property held for sale to customers in the ordinary course of business.

[19] *E.g.*, six months for property acquired after June 22, 1984 and before January 1, 1988.

[20] The allocation of rent to the real and personal properties under a lease generally is based on the relative adjusted bases of the leased properties. If the rent attributable to personal property under this allocation is greater than 15 percent of the total rent under the lease, then all rent attributable to personal property from the lease will be treated as nonqualifying income.

[21] Similar rules apply in determining whether interest income is treated as qualifying income.

Customary services.—In general, under prior and present law, services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the collection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856-4(b)).

Treatment of shared appreciation mortgages

Under prior law, the treatment of a portion of the income arising from a so-called "shared appreciation mortgage" for purposes of the REIT income requirements was not certain. In general, a shared appreciation mortgage is a debt obligation that is secured by real property, which debt obligation requires the obligor to pay to the holder a portion of any gain realized by the obligor on the sale of real property securing the obligation.

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, under prior law, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and Government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the entity's assets can be invested in securities of any one issuer (other than a government or a REIT), which securities comprise more than five percent of the entity's assets or more than 10 percent of the outstanding voting securities of such issuer (sec. 856(c)(5)(B)). The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs (sec. 856(c)(6)(B)). Interests in real property include fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but do not include mineral, oil, or gas royalty interests (sec. 856(c)(6)(C)).

Distribution requirements

Overview

To satisfy the distribution requirement, under prior law, an entity must distribute as dividends to its shareholders during the taxable year an amount equal to at least the excess of (a) the sum of (i) 95 percent[22] of its REITTI other than net capital gain income, and (ii) 95 percent[23] of the entity's net income from foreclosure property less the tax imposed on such income, over (b) the sum of (i) penalty taxes imposed under section 6697 (resulting from the distribution of "deficiency dividends") and (ii) the net loss from prohibited transactions (sec. 857(a)(1)).

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[22] This requirement is 90 percent for taxable years beginning before January 1, 1980.

[23] This requirement is 90 percent for taxable years beginning before January 1, 1980.

Distributions after the taxable year

Certain distributions within 12 months of the end of the taxable year.—Under prior and present law, if a REIT declares a dividend prior to the time for filing its tax return for a taxable year and actually pays such dividend within 12 months of the end of such taxable year (but not later than the date of the next regular payment after the declaration), then the REIT may elect to have the dividend treated as having been paid in the preceding taxable year (sec. 858(a)). Notwithstanding the election, the distributees are treated as having received the dividend in the year in which the distribution is made (sec. 858(b)).

Under prior law, to partially compensate for the deferral of tax liability that may occur where a REIT pays such so-called "spillover dividends," a nondeductible three percent excise tax is imposed on the amount of such dividends to the extent that 75 percent of the REITTI of the REIT for the preceding taxable year without regard to the dividends paid deduction and certain other adjustments (as reported on the REIT's tax return) exceeds the amount distributed in such year (sec. 4981).[24]

Other distributions after the end of the taxable year—deficiency dividends.—Under prior and present law, where, as a consequence of an audit by the Internal Revenue Service, there has been a "determination" that an "adjustment" is to be made to REITTI for a taxable year, the entity may pay a deficiency dividend to its shareholders and receive a deduction for such distributions with regard to the taxable year for which the election is made, provided that the adjustment did not occur as a result of fraud or willful failure to file an income tax return (sec. 860). If the proper amount is distributed as a deficiency dividend, the entity is not disqualified as a REIT or subject to tax on the amounts distributed (but is subject to interest and penalties). Interest and penalties relating to amounts distributed as deficiency dividends are based on the amount of the adjustment.[25]

In addition to other penalties provided under the Code relating to underpayments of tax, under prior law, section 6697 of the Code imposed a penalty equal to the amount of interest attributable to the amount paid by a REIT as a deficiency dividend. The amount of this penalty is limited to one half of the amount of the deficiency dividend.

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[24] Amounts counted toward the 75-percent requirement are only amounts that qualify for the dividends paid deduction for the current year. Therefore, any spillover dividends or deficiency dividends (which relate only to a prior year) are not counted toward this 75-percent requirement.

[25] For this purpose, the amount of the adjustment would include adjustments attributable both to ordinary income and capital gains. However, no interest and penalties are assessed in the event of the late designation of a capital gains dividend where the amount was distributed previously as an ordinary income distribution.

Reasons for Change

The Congress believed that certain aspects of the requirements for qualification and taxation of REITs should be modified. Generally, the modifications are required in order to allow REITs to enter into transactions, or otherwise structure their affairs, in either case consistent with both prevailing market conditions and the general requirement that a REIT is an entity whose primary purpose is to derive most of its income from passive real estate related sources and distribute most of its income to its shareholders.

The Congress understood that certain of the REIT requirements present significant difficulties in connection with the initial election by an entity of REIT status. For example, new corporations that are formed for the purpose of electing REIT status may have difficulty meeting the shareholder diversification requirement in their first year because of delays in the distribution of their shares. The Congress believed that for the first year that an entity otherwise meets the requirements to elect REIT status, failure to meet the shareholder diversification requirement should not result in disqualification.

The Congress also understood that a corporation that is formed for the purpose of becoming a REIT often may initially adopt a fiscal year ending a few months after its incorporation, intending to change its taxable year to the calendar year required of REITs immediately after the end of the first fiscal year. The reason that this is done is that the new corporation would not be able to qualify as a REIT for its first taxable year if the calendar year were elected initially. In this situation, the Congress believed that the entity should be permitted to change its taxable year to a calendar year without permission of the Internal Revenue Service.

The Congress also believed that an entity wishing to elect REIT status for the first time should not be permitted to do so if it has earnings and profits accumulated as a C corporation. Accordingly, the Act provides that any C corporation having accumulated earnings and profits is required to distribute such accumulated earnings and profits in order for it to qualify as a REIT.

The Congress also understood that both newly electing and existing REITs may encounter difficulty meeting the 75 percent income test after they receive a significant amount of new equity capital. For example, such amounts may be received as a result of a public offering of stock, but the process of investing such amounts in appropriate assets producing rents or other income qualifying for the 75 percent income test may take sufficiently long so that the entity may not be able to satisfy the requirement for the year. The Congress recognized the impracticality of requiring REITs to identify their chosen real estate investments prior to raising any new equity capital, and believed that REITs should be afforded some relief from the 75 percent income test for one year after receiving the new equity capital. The Congress similarly believed that analagous relief should be available where a REIT receives new debt capital as a result of a public offerring of long term debt securities. The Congress believed, however, that consistent with the general passive nature of the REIT, the relief should be available only to the extent that the income from the investment of new equity consists of income from either stock or debt instruments.

The Congress understood that, for purposes of limiting liability, separate parcels of real estate commonly are held in separate, but commonly owned, corporations. Since stock in a corporation other than a REIT is not treated as a real estate asset, REITs effectively are prevented from holding their real estate assets in separate corporations. The Congress believed that whether a REIT is considered to meet the asset requirement should be determined by treating assets held by wholly owned subsidiaries as owned directly by the REIT.

The Congress believed that two of the requirements of present law, that are intended to assure that the REIT is more a passive entity than one engaged in an active trade or business, may be overly restrictive and should be liberalized consistent with maintaining the essential passivity of the REIT. First, the Congress believed that REITs should be permitted to perform certain services in connection with the rental of real property without being required to use an independent contractor (to assure that rents from such property are considered to qualify as "rent from real property"). The Congress believed that the same standard should be applied to REITs for the purpose of determining whether amounts being received are from the passive rental of real property or from an active trade or business, that is applied to tax-exempt entities in determining whether amounts are treated as income from an "unrelated trade or business." Second, the Congress believed that the prohibited transaction safe harbor of present law should be liberalized, in part by extending the safe harbor to include any number of transactions so long as the adjusted basis of property sold in such transactions does not exceed a fixed percentage of the adjusted basis of all of the REIT's assets.

The Congress understood that lessors of real property frequently lease property to a prime tenant and agree to accept as rent a fixed amount plus a percentage of the prime tenant's profits from the rental of the property. Since the rent from the prime tenant is based in part on the prime tenant's net profits in such a transaction, the portion based on the net profits would not qualify as rents from real property for the REIT. Nevertheless, if the prime tenant's rent from the property is dependent only on rents received from the property, (including rents based on the gross receipts of the subtenants), then the REIT in this situation is not participating in the profits of any active business other than that pertaining to the rental of its own property. Accordingly, the Congress believed that rents that are based on the net income of the tenant should be treated as qualifying rents for the REIT provided that the tenant's profits are derived only from sources that would be qualifying rent from real property if earned directly by the REIT.

The Congress believed that the treatment of income from shared appreciation mortgages should be clarified for purposes of the REIT income requirements. In general, the Congress believed that for these purposes it was appropriate to treat the income from the shared appreciation provision as gain from the sale of the related real property.

If a REIT sells property in exchange for obligations bearing original issue discount, or enters into deferred rental agreements (within the meaning of sec. 467), the REIT may be required to recognize income in advance of receiving cash, on account of changes to law made by the Deficit Reduction Act of 1984.[26] Since the REIT's distribution requirement is based on its REITTI which does not necessarily take into account cash received, a REIT might have to borrow up to 95 percent of the amount of income that it is required to recognize on account of section 467 or section 1274 in order to meet its distribution requirement. A similar situation arises where the REIT enters into a transaction that it believes in good faith to meet the requirements for eligibility as a tax-free exchange under section 1031, but the transaction later is determined not to qualify.

The Congress believed that REITs should be permitted some relief from the distribution requirement in these circumstances. The Congress recognized that the distribution requirement, which is 95 percent, already takes into account the possibility of the REIT having certain amounts of income not accompanied by cash, and that the relief extended should reflect this feature of the requirement. Accordingly, the Act reduces the amount that the REIT otherwise would be required to distribute by the amount that these types of noncash income exceed 5 percent of REITTI. In order that this relief not result in deferral of tax on the related income, the REIT is required pay tax on the undistributed amount.

The Congress believed that a fundamental purpose for permitting conduit treatment for REITs is to enable small individual investors the opportunity to invest in a professionally managed diversified portfolio of real estate assets. Hence, the Congress believed that if a REIT is required to offset its capital gain income with net operating losses, individual investors routinely are denied the benefit of capital gain treatment that they would receive if they were able to hold the real estate assets directly. Thus, the Act provides that REITs may preserve the availability of capital gains treatment even if they have net operating losses. In addition, the Congress believed that the notification procedure for capital gain dividends may be accomplished with less of a burden on the REIT if the REIT were permitted to mail its capital gain notices with its annual report, and the Act so provides.

The Congress believed that the ability of a REIT to pay spillover dividends, (or in the case of REITs that have taxable years other than the calendar year, dividends after the end of a calendar year out of income earned during the calendar year), without penalty should be further restricted in order to prevent the deferral of income recognition that may accompany the payment of such amounts. Accordingly, the Congress believed that the excise tax under section 4981 should be raised to 4 percent, and that REITs should be required to distribute larger amounts of income (both capital gain and ordinary income) than presently required to avoid the imposition of the excise tax.

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[26] P.L. 98-369.

Finally, the Congress believed that the imposition of interest and penalties relating to deficiency dividends based on the full amount of such dividends adequately compensates the Federal government for the deferral of tax liability that takes place when a REIT distributes less than is required for a taxable year. Accordingly, the penalty tax under section 6697 is repealed under the Act.

Explanation of Provisions

Overview

The Act modifies many of the provisions relating to the requirements for qualification as and the taxation of REITs. The provisions modified relate to the general requirements for qualification as a REIT, the income and asset requirements for qualification as a REIT, the definition of rents and interest, the distribution requirements for qualification as a REIT, the treatment of capital gains, the provisions relating to prohibited transactions, and certain other provisions.

General requirements

Under the Act, as under prior law, an entity generally may not elect REIT status if it would meet the stock ownership test of section 542(a)(2) (i.e., if it would be treated as a personal holding company if all of its income constituted personal holding company income) or if it had fewer than 100 shareholders. Under the Act, however, an entity that otherwise meets the applicable requirements may elect REIT status notwithstanding its meeting the section 542(a)(2) stock ownership test or its having fewer than 100 shareholders, provided that the entity was not a REIT in any prior year. In applying the attribution rules of section 544 for purposes of determining whether the stock ownership requirement of section 542(a)(2) is met for any taxable year, attribution to an individual of stock owned by or for the individual's partner is ignored under the Act.

The Act provides that, in order to elect REIT status, the electing entity must either have been treated as a REIT for all taxable years beginning after February 28, 1986 or must have no earnings and profits accumulated for any year in which the entity was in existence and not treated as a REIT.

The Act also provides that an entity that has not engaged in any active trade or business is permitted to change its annual accounting period to a calendar year without approval of the Internal Revenue Service in connection with electing REIT status. This rule is intended to apply to entities that are newly formed for the purpose of becoming a REIT, and that wish to adopt a calendar year taxable year after an initial period in which, for example, the entity receives the proceeds of a stock offering and temporarily invests such proceeds in passive investments until investment in suitable real estate assets is made.

Income and asset requirements

REIT subsidiaries

Under the Act, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence.[27] If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.[28]

For example, an entity owns 100 percent of the stock of a corporation that holds an office building and receives rental income from the office building. For purposes of determining whether the shareholder entity qualifies for REIT status, the shareholder is treated as owning the office building directly and as receiving the rents therefrom. If the shareholder qualifies as a REIT, the separate existence of the 100 percent owned subsidiary is ignored for all income tax purposes. If the shareholder REIT sells all of the stock in the subsidiary to any purchaser (including another REIT), then the subsidiary is treated as a new corporation that was formed and that received its properties in exchange for its stock, immediately after which it was owned by the purchaser. Hence, the Congress anticipates that the deemed transfer of the assets to the subsidiary in exchange for its stock would not qualify as a tax-free exchange under section 351 in this situation.

The Congress intended that if a REIT purchases all of the stock of a corporation and makes an election under section 338 with respect to the purchased stock, then the corporation that is deemed to be newly formed pursuant to the section 338 election may qualify as a REIT subsidiary as of the time that the newly formed corporation is deemed to come into existence.

New equity or debt capital

Under the Act, if a REIT receives new equity capital, then income derived from stock or debt instruments (i.e., interest, dividends, or gains from the sale of such stock or debt instruments) that is attributable to the temporary investment of the new equity capital is treated, for a one-year period beginning on the date that the REIT receives such capital, as qualifying income for purposes of the "75 percent income test."[29] In addition, during such period, stock or debt instruments purchased with such capital are treated as "real estate assets" for purposes of the "75 percent asset test." Under the Act, new equity capital is any amount received by the REIT in exchange for stock of the REIT (other than pursuant to a dividend reinvestment plan).

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[27] The Congress intended that any entity that is treated as a corporation within the meaning of section 7701(a)(3) may qualify as a REIT subsidiary.

[28] In the case of the shareholder REIT ceasing to be treated as a REIT, the Congress intended that the transfer would be deemed to take place as of the first day of the first taxable year in which the entity's REIT status ceases.

[29] Nevertheless, the REIT would continue to be required to meet the "95 percent income test" including income from the new equity capital. For this purpose, the Congress intended that the term "debt instrument" is to have the same meaning as under section 1275(a)(1).

The Act also provides that the investment of the proceeds of the public offering of debt securities that have a maturity of at least five years receives the same treatment as the investment of new equity capital. The Congress intended that debt securities for which there is an intention to call before five years would not be treated as having a maturity of at least five years.

Definition of rents and interest

Independent contractor requirement

Under the Act, amounts received by a REIT in connection with the rental of property do not fail to qualify as rents from real property merely because the REIT performs certain services and does not use an independent contractor for the provision of such services. Under the Act, the services that may be provided without violating the "independent contractor test" are those services the provision of which would not by reason of section 512(b)(3) result in the receipt of "unrelated business income" by an organization subject to tax on such income (sec. 511(a)(2)). Thus, under the Act, amounts received by the REIT in connection with the rental of real property would not fail to be treated as rents from real property if the REIT provides only certain services other than services that are considered rendered to the occupant of the property (Treas. Reg. sec. 1.512(b)-1(c)(5)). The Act does not alter the provision of prior law under which amounts received by a REIT are treated as rents from real property if the REIT provides "customarily furnished services" to its tenants through an independent contractor.

The Congress intended, for example, that a REIT may provide customary services in connection with the operation of parking facilities for the convenience of tenants of an office or apartment building, or shopping center, provided that the parking facilities are made available on an unreserved basis without charge to the tenants and their guests or customers. On the other hand, the Congress intended that income derived from the rental of parking spaces on a reserved basis to tenants, or income derived from the rental of parking spaces to the general public, would not be considered to be rents from real property unless all services are performed by an independent contractor. Nevertheless, the Congress intended that the income from the rental of parking facilities properly would be considered to be rents from real property (and not merely income from services) in such circumstances if services are performed by an independent contractor.

The Congress also intended that a REIT may directly select, hire, and compensate those independent contractors who will provide the customary services that may be provided by a REIT in connection with the rental of real property, rather than hiring an independent contractor to hire other independent contractors.

Rents and interest based on net income

Under the Act, rents or interest that are based on the net income of a tenant or debtor are treated as rent from real property or as interest, respectively, if certain conditions are met. To qualify, the rent (or interest) must be received from a tenant (or debtor) that receives substantially all of its income from the leased property (or the property that secures the loan) from the subleasing (or leasing) of substantially all of such property, and the rent received by the tenant (or debtor) consists entirely of amounts that would be treated as rents from real property (or interest) if received directly by the REIT.[30] However, if the tenant (or debtor) receives rents (or interest) from the property a portion of which would qualify as rents from real property (or interest) for the REIT and a portion of which would not, then the same rules that apply under prior law apply under the Act, whereby a proportionate part of the amount received by the REIT would be treated as rent from real property (or interest).[31]

Shared appreciation provisions

The Act provides that for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, the Act provides that for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property),[32] and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.[33]

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[30] Thus, for example, rents based on the net income of a tenant of the REIT who provides services to its subtenants, which services a REIT would be required to provide through an independent contractor in order for the REIT to be treated as receiving rents from real property, could not be treated as rents from real property by the REIT unless the tenant provides such services through a contractor that is independent with respect to the tenant.

[31] A technical correction may be necessary to achieve this result.

[32] The Congress intended that the provisions of section 1223 are to be taken into account for purposes of determining the holding period of the person holding the secured property.

For example, under the Act, if a REIT is the holder of an obligation under which it is paid a fixed percentage of interest on a fixed principal amount, and also is entitled to a payment equal to a portion of the appreciation in the property as of the time the property is sold (or at an earlier specified time), then the additional payment would be treated as gain on the sale of the property secured by the obligation for purposes of section 856(c), with the holding period of the property considered to be the shorter of the REIT's holding period of the obligation or the obligor's holding period for the secured property. This gain would be eligible for the prohibited transaction safe harbor if the applicable requirements are met.

The Congress intended no inference regarding the treatment of any shared appreciation provision for any other purposes of Federal income taxation.

Distribution requirement

Under the Act, the minimum amount that the REIT is required to distribute (i.e., the minimum dividends paid deduction as specified in sec. 857(a)(1)), is reduced by a portion of certain amounts that the REIT is required to include in income in advance of receiving cash. These amounts are (1) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting,[34] (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan,[35] and (3) any income arising from the disposition of a real estate asset, but only in circumstances where the REIT had entered into a transaction with respect to such real estate, had intended in good faith that the transaction qualify as a like-kind exchange under section 1031, the income is recognized as a result of a determination that the transaction did not so qualify, and the failure to meet the requirements of section 1031 was due to reasonable cause and not due to willful neglect. The portion of such amounts by which the REIT's minimum distribution requirement is reduced is the amount by which the sum of these amounts exceeds five percent of the REITTI of the REIT determined without regard to the REIT's dividends paid deduction and net capital gain.[36]

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[33] The Congress intended that the REIT's holding period of the obligation to which the shared appreciation provision relates (and not the obligor's holding period of the secured property if longer than the REIT's holding period) must be at least four years for the safe harbor to apply.

[34] Thus, for example, in the case of a REIT using the accrual method of accounting, the provision would apply in the case of a section 467 rental agreement only to the extent that the income required to be recognized under section 467 exceeded the amount of income that the taxpayer would include under the accrual method if section 467 did not apply.

[35] A technical correction may be necessary so that the statute reflects this intent.

[36] The computation of REITTI would take into account the change made by the Act, which would permit the deduction of the REIT's net loss from prohibited transactions, as described below.

Capital gains

Under the Act, for purposes of determining the maximum amount of capital gain dividends that a REIT may pay for a taxable year, the REIT would not offset its net capital gain with the amount of any net operating loss, whether current or carried over from a previous taxable year. To the extent that the REIT then elects to pay capital gain dividends in excess of its net income, the REIT would increase the amount of its net operating loss carryover by such amount. For example, a REIT with no net operating loss carryovers incurs a $100 net operating loss and has a net capital gain of $50 in 1987. Under the Act, the maximum amount of capital gain dividends that the REIT could distribute is $50. If the REIT distributed a $40 capital gain dividend, its net operating loss carryover to the succeeding taxable year would be $90.

Under the Act, REITs are permitted to mail the required capital gain notices to shareholders with the REIT's annual report rather than within 30 days of the end of the taxable year. The Congress intended that if the REIT does not regularly provide its shareholders with an annual report, then the notice requirement of prior law would continue to apply.

Prohibited transaction rules

The Act makes two modifications to the rules relating to prohibited transactions. First, the Act modifies the safe harbor under which sales by the REIT meeting the conditions of the safe harbor are not treated as prohibited transactions. Under the Act, the number of sales of property that a REIT may make within the safe harbor is increased from five to seven. In addition, the extent of expenditures that the REIT may make within four years of sale that are includible in the basis of the property is increased from 20 percent of the net selling price of the property to 30 percent.

The Act also provides an alternative safe harbor whereby the REIT may make any number of sales during the taxable year, provided that the adjusted basis of the property sold does not exceed 10 percent of the adjusted basis of all of the REIT's assets at the beginning of the REIT's taxable year. For this purpose, the total adjusted basis of all of the REIT's assets (including the property that is sold) is to be computed using depreciation deductions that are used for purposes of computing earnings and profits. A sale is treated as qualifying for the alternative safe harbor, however, only if substantially all the marketing and development expenditures with respect to the property sold were made through an independent contractor. The determination of whether a particular sale qualifies for the prohibited transaction safe harbor is made on a property by property basis. The Congress intended no inference regarding whether sales that qualify under this safe harbor for the REIT are or are not properly considered to be sales of property held for sale to customers.

Second, the Act provides that in determining the amount of net income derived from prohibited transactions, losses from prohibited transactions (and deductions attributable to prohibited transactions in which a loss was incurred) may not be taken into account. The Act does, however, provide that the amount of any net loss from prohibited transactions may be taken into account in computing REITTI. For example, for a taxable year a REIT has a net gain from a prohibited transaction of $100 and a net loss from a prohibited transaction of $50. The REIT has net rental income of $200 and no other items of income or deduction. Under the Act, the REIT would be subject to a $100 tax on the gain from its prohibited transaction, and its REITTI would be $150.

Deficiency dividends

Under the Act, the penalty tax under section 6697 on deficiency dividends is repealed.

Imposition of excise tax

In general

The Act imposes a nondeductible excise tax on any REIT for each calendar year equal to four percent of the excess, if any, of the "required distribution" for the calendar year, over the "distributed amount" for such calendar year. The excise tax must be paid on or before March 15 of the following calendar year.

For these purposes, the term required distribution means, with respect to any calendar year, the sum of (1) 85 percent of the REIT's "ordinary income" for the calendar year, (determined as if the calendar year were the REIT's taxable year), (2) 95 percent of the REIT's capital gain net income (within the meaning of sec. 1222(9)) for such calendar year, (determined as if the calendar year were the REIT's taxable year), and (3) the excess, if any, of the "grossed up required distribution" for the preceding calendar year over the distributed amount for such preceding calendar year. For this purpose, the term grossed up required distribution for any calendar year is the sum of the taxable income of the REIT for the calendar year (without regard to the deduction for dividends paid) and all amounts from earlier years that are not treated as having been distributed under the provision.

The REIT's ordinary income for this purpose means its real estate investment trust taxable income (as defined in sec. 857(b)(2)) determined (1) without taking into account the dividends paid deduction, (2) by not taking into account any gain or loss from the sale of any capital asset, and (3) by treating the calendar year as the REIT's taxable year.

In addition, for these purposes, the term distributed amount means, with respect to any calendar year, the sum of (1) the deduction for dividends paid (within the meaning of sec. 561) during such calendar year, (2) amounts on which the REIT is required to pay corporate tax, and (3) the excess (if any) of the distributed amount for the preceding taxable year over the grossed up required distribution for such preceding taxable year. The amount of dividends paid for these purposes is determined without regard to the provisions of section 858.

Under the Act, for purposes of applying these provisions, any deficiency dividend, (as defined in sec. 860(f)), is taken into account at the time it is paid, and any income giving rise to the adjustment is treated as arising at the time the dividend is paid.

Although the excise tax is imposed only for calendar years beginning after December 31, 1986, the computations that are necessary to determine whether any excise tax is due and the amount so due, will require certain calculations involving income, losses, and distributions with respect to periods before the first calendar year for which the excise tax is imposed. For example, in computing the excise tax for the first calendar year beginning after December 31, 1986, computation of the grossed up required distribution and distributed amount for the calendar year ending on December 31, 1986 is required.[37]

Timing of inclusion of certain dividends

Under the Act, any dividend declared by a REIT in December of any calendar year and payable to shareholders of record as of a specified date in such month, shall be deemed to have been paid by the REIT, (including for purposes of sec. 561), and to have been received by each shareholder, on such record date, but only if such dividend is actually paid by the REIT before February 1 of the following calendar year. This provision does not apply for purposes of section 858(a), however.

Earnings and profits

Under the Act, a REIT is treated as having sufficient earnings and profits to treat as a dividend any distribution during any calendar year (other than a redemption to which sec. 302(a) applies), which distribution is treated as a dividend by such REIT, but only to the extent that the amount distributed during such calendar year does not exceed the required distribution for such calendar year. The purpose of this provision is to prevent the REIT from failing to meet the requirements for avoiding the imposition of the excise tax where losses incurred by the REIT after December 31, but before the close of its taxable year, otherwise would prevent the REIT from having sufficient earnings and profits for its distributions to be treated as dividends.

Treatment of certain capital losses

The Act provides that, in the case of a REIT that has a taxable year other than the calendar year, for purposes of determining the amount of capital gain dividends, such REIT may distribute for a taxable year, the REIT's net capital gain for the taxable year is determined without regard to any net capital loss attributable to transactions after December 31 of such year. For these purposes, any such net capital loss is treated as arising on the first day of the next taxable year. To the extent provided in Treasury regulations, the same rule will apply for purposes of determining the REIT's taxable income.[38]

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[37] Although the statutory definition of the grossed up required distribution seems to require computations of a REIT's income and distributions beginning with the commencement of the REIT's existence, it is anticipated that REITs will be able to derive the proper grossed up required distribution without taking into account periods prior to the first taxable year of the REIT ending before January 1, 1987. In general, after taking into account spillover dividends, all income for all taxable years ending before January 1, 1987 would either have been distributed to shareholders or taxed to the REIT, and thus would be treated as distributed amounts under section 4981(c). In calculating these amounts, the Congress intended that proper adjustments will be made for periods in which the corporation did not qualify as a REIT.

Effective Date

The provisions of the Act generally are effective for taxable years beginning after December 31, 1986. The provisions relating to the imposition of the excise tax are effective for calendar years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal budget receipts by $37 million in 1987, and less than $5 million annually in 1988 through 1991.

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[38] The Congress intended that any such regulations would prevent the avoidance of tax, particularly in circumstances where a REIT takes advantage of the rule in order to pay return of capital dividends in the following taxable year, or to offset the tax that would be incurred on capital gains recognized in the following year.

P. Mortgage-Backed Securities (Secs. 671-675 of the Act and secs. 1272, 6049, 7701, and new secs. 860A-860G of the Code) [39]

Prior Law

Taxation of alternative methods of owning income producing assets

Overview

Under prior and present law, income-producing assets (such as mortgages on residential property or other debt instruments) can be owned directly, or they can be owned indirectly by means of an equity interest in an intermediary entity. Income generated by property that is owned directly generally is taxed to the owner of the property. Thus, in the case of property owned directly by an individual, income from such property is subject to only one level of taxation. Income from property owned indirectly may be subject to more than one level of taxation, i.e., tax may be imposed both at the level of the intermediary holder and the indirect owner.

Whether more than one level of tax is imposed where income producing property is held indirectly generally depends on whether the intermediary entity is treated for tax purposes (1) as a separate taxable entity (such as a corporation or an association taxable as a corporation), (2) as a complete conduit entity (such as a partnership or S corporation), or (3) as a partial conduit entity (such as a trust or real estate investment trust) under which income is not taxed to the entity to the extent it is currently distributed to the entity's owners.

Direct ownership of income producing assets

Individual ownership

The most basic form of direct ownership of income producing assets is the holding of such assets by an individual. Where an individual owns income producing assets directly, the individual generally includes all income generated by the property, and deducts all items of expense related to the property. When the individual disposes of the property in a taxable transaction, the individual recognizes gain or loss, which may be capital gain or loss.

Grantor trusts

A grantor trust is an arrangement under which legal title to property is transferred to a trustee, but the transferor retains certain powers over, or interests in, the trust so that the transferors are treated as retaining direct ownership of such property for Federal income tax purposes (secs. 671-679). Thus, income, deductions, and credits of the grantor trust are attributed directly to the grantors.[40]

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[39] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1441-1445; S.Rep. 99-313, pp. 783-801; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 222-241 (Conference Report).

Indirect ownership of income producing assets

Separate taxable entities—corporations

One form of indirect ownership of income producing property is the ownership of stock in a corporation that owns such property. Corporations can be used to hold investment property or to engage in the active conduct of a trade or business.

Corporations generally are treated for tax purposes as separate taxable entities, apart from their shareholders.[41] Thus, income earned by a corporation is taxed to the corporation. In addition, when the after-tax earnings of a corporation are distributed to the corporation's stockholders as dividends, generally such earnings also are taxed to the stockholders.[42]

Interest on debt incurred by a corporation to finance the acquisition of income-producing assets generally is deductible to the corporation incurring the debt. To the extent that income from debt-financed property is paid to the debtholders in the form of interest, the interest deduction offsets any corporate-level tax on such income, resulting in the imposition of only a single tax on the income, which tax is borne by the debtholder.

Complete conduit entities

Partnerships.—Another form of indirect ownership of income producing assets is ownership of an interest in a partnership holding such assets. A partnership generally is treated as a complete conduit for Federal income tax purposes.[43] Each partner accounts for his "distributive share" of the partnership's income, loss, deduction, and credit. The liability for income tax is that of the partner, and not of the partnership, without regard to whether the income of the partnership is actually distributed to the partners. Partnership losses, deductions, and credits pass through to the partners and can be used to offset other income. In general, an entity is treated as a partnership if it is an unincorporated organization through, or by means of which, any business, financial operation or venture is carried on, and it is not treated as a corporation, a trust, or an estate.[44]

S corporations.—Income producing property also may be owned indirectly through ownership of stock in an S corporation. Although S corporations are corporate entities, if a corporation so elects, its shareholders generally may account for a proportionate amount of the corporation's items of income, loss, deduction, and credit under subchapter S of the Code (secs. 1361 *et seq.*). The S corporation itself generally has no tax liability for as long as the election is in effect.[45]

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[40] In some cases, persons other than the transferors are treated as owners of the trust's assets.

[41] Certain corporations may be treated as complete or partial conduit entities, however. *See* discussion of S corporations and real estate investment trusts, below.

[42] Under prior law, an individual generally was allowed to exclude from taxable income up to $100 of dividends per year ($200 for a joint return) (sec. 116), and corporations were entitled to a dividends received deduction for 85 or 100 percent of dividends received (secs. 243-245). Section 612 of the Act repeals the limited dividend exclusion for individuals, and section 611 of the Act reduces the 85 percent dividends received deduction for corporations to 80 percent.

[43] A partnership is treated as an entity separate from its partners for purposes of calculating items of taxable income, deduction, and credit. It also is treated as an entity for purposes of reporting information to the Internal Revenue Service.

[44] *See* discussion of entity classification, below.

In general, a domestic corporation may elect to be treated under subchapter S if it has 35 or fewer shareholders (none of whom are corporations or nonresident aliens), has not more than one class of stock, and is not a financial institution, a life insurance company, or one of several other types of corporations.

Partial conduit entities

Real estate investment trusts.—Another form of indirect ownership is the ownership of shares or interests in a real estate investment trust ("REIT"). Under the provisions of the Code applicable to REITs (secs. 856 *et seq.*), REITs generally are treated as conduits for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders is taxed at the REIT level, as in the case of ordinary corporations.

In general, an entity may qualify as a REIT if it is a trust or corporation with at least 100 different freely transferable interests, which trust or corporation would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being in substantial part realized from certain real estate and real estate related sources.

The ability of a REIT to engage in regular business activities is limited by the requirement that income from the sale or other disposition of stock or securities held for less than 1 year, or real property held less than 4 years, must account for less than 30 percent of the REIT's income. Further, a 100 percent tax is imposed on gains from the sale of property held for sale to customers in the ordinary course of trade or business (other than foreclosure property).

If a corporation meets these requirements and elects to be treated as a REIT, it generally is subject to the regular corporate tax, but receives a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 95 percent of its ordinary income. These dividends must be paid within a short period following the close of the REIT's taxable year and are generally includible as ordinary income to the shareholders.[46]

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[45] An S corporation may be subject to tax at the entity level under certain limited circumstances.

[46] A deficiency dividend procedure was added to the REIT provisions as part of the Tax Reform Act of 1976 so that a REIT, acting in good faith but failing to satisfy the distribution requirement, could avoid disqualification. In addition, section 668 of the Act imposes an excise tax that is intended to ensure that a REIT distributes most of the income earned in a calendar year during that year.

A REIT that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the REIT pays dividends out of such capital gains, the dividends are deductible by the REIT in computing its capital gains tax and are taxable as capital gains to the recipient shareholders.

RICs.—Conduit treatment similar to that granted to REITs also is provided to regulated investment companies ("RICs"). In general, a RIC is an electing domestic corporation that either meets or is excepted from certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified sources commonly considered passive investment income, that has a portfolio of investments that meet certain diversification requirements, that distributes at least 90 percent of its income to its shareholders annually, and that also meets certain other requirements.

The ability of a RIC to engage in an active business is limited by a requirement that less than 30 percent of the gross income of the RIC may be derived from gain on the sale or other disposition of stock or securities held for less than three months.

A RIC, like a REIT, generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders. Rules similar to those applicable for REITs apply to distributions of capital gain dividends, and distributions of deficiency dividends.[47]

Trusts.—Another form of indirect ownership of property is ownership of the beneficial interest of property that is held in a trust. A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property. A trust generally is treated as a partial conduit for Federal income tax purposes since the trust, although in form a separate taxable entity, is allowed a deduction for amounts distributed to its beneficiaries, which amounts generally are includible in the beneficiaries' income.

A fixed investment trust is a trust used to hold a diversified portfolio of investments for its beneficiaries. Generally, such a trust is treated as a trust for tax purposes (and not as an association) if the trustee does not have the power to vary the investments of the trust.[48]

Rules for classifying entities

Corporation or partnership

Under prior and present law, Treasury regulations provide that whether a particular entity is classified as an association taxable as a corporation or as a partnership, trust, or some other entity not taxable as a corporation is determined by taking into account the presence or absence of certain characteristics associated with corporations. These characteristics are (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for entity debts limited to entity property, and (6) free transferability of interests.[49] These regulations generally are based on the principle stated in *Morrissey* v. *Commissioner*, 296 U.S. 344 (1935), in which the Supreme Court held that whether an entity is treated as a corporation depends not on the form of its organization, but on whether it more closely resembles a corporate than a noncorporate entity.

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[47] In addition, section 651 of the Act imposes an excise tax that is intended to ensure that a RIC distributes most of the income earned in a calendar year during that year.

[48] *See* discussion of entity classification, below.

Of the characteristics mentioned above, the first two are common to both corporate and partnership enterprises. Consequently, the remaining four factors are determinative of whether the entity is treated as a corporation or as a partnership. Treasury regulations state that the corporate characteristics of an entity must make it more nearly resemble a corporation than a partnership or a trust for the entity to be treated as a corporation.[50] Under this test, the Treasury regulations provide that most limited partnerships formed under the Uniform Limited Partnership Act are not treated as corporations since these entities generally do not possess continuity of life and also may lack limited liability.

Trust or association

Since both corporations and trusts generally possess centralization of management, continuity of life, free transferability of interests, and limited liability, the Treasury regulations provide that the determination of whether a particular unincorporated entity is treated as a trust or as an association taxable as a corporation depends on whether there are associates and an objective to carry on business and divide the gains therefrom.[51] Generally, if the purpose of an arrangement is to grant to trustees exclusive responsibility for the protection and conservation of trust property, and the persons with the beneficial interest in the property cannot share in the discharge of that responsibility, there are no associates or an objective to carry on business. Such an arrangement generally will be treated as a trust.[52] On the other hand, if a trust is used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership, it will not be treated as a trust.[53] However, a trust that is used to hold income-producing assets may be treated as a trust if there is no power under the trust agreement to vary the investment.[54]

In May, 1984, the Treasury Department issued proposed regulations addressing the treatment of trusts that have more than one class of ownership interest. Final regulations were issued by the Treasury Department in March, 1985 (Treas. Reg. sec. 301.7701-4(c)(1)). Under these regulations, a trust is treated as having one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. More than one class of ownership may exist where, for example, some beneficiaries are entitled to receive more than their pro rata share of trust distributions in early years and other beneficiaries are entitled to more than their pro rata share in later years.

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[49] Treas. Reg. sec. 301.7701-2(a).
[50] *Id.*
[51] Treas. Reg. sec. 301.7701-2(a)(2).
[52] Treas. Reg. sec. 301.7701-4(a).
[53] Treas. Reg. sec. 301.7701-4(b).
[54] Treas. Reg. sec. 301.7701-4(c).

Under the Treasury regulations, an arrangement having more than one class of ownership interest generally may not be treated as a trust, but is treated as a corporation. Thus, if a trust held a portfolio of mortgages, and interests in the trust assets were divided so that one class of beneficiaries were to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal on the mortgages, and another class of beneficiaries were to receive all remaining amounts collected by the trust, then such trust would be treated as an association taxable as a corporation under these regulations. The Treasury regulations provide a limited exception for certain trusts with multiple classes, where the existence of multiple classes is incidental to the purpose of facilitating direct investment in the assets of the trust. The Treasury regulations apply to interests issued after April 27, 1984.

Taxation of income from debt obligations

The original issue discount rules

Treatment of original issue discount as interest

Under prior and present law, if the borrower receives less in a lending transaction than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[55] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[56]

Definitions

"Original issue discount" is defined as the excess of a debt instrument's "stated redemption price at maturity" over its "issue price" (provided such excess is not less than a certain de minimis amount).

"Issue price" generally is (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,[57] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, an amount determined using an adequate interest rate.

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[55] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[56] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984 greatly expanded the number and types of obligations to which the OID rules apply.

[57] Presently, only stock or securities traded on an established securities market are treated as publicly traded. However, section 1803(a)(10) of the Act grants the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

"Stated redemption price at maturity" includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period." The accrual period generally is each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months prior to the date of maturity.[58] The adjustment to the issue price for each accrual period is determined by multiplying the "adjusted issue price" (i.e., the issue price increased by adjustments prior to the beginning of the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period.

The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction. The holder's basis in the obligation is increased by the amount of OID includible in the holder's income.[59] Under prior law, there was uncertainty about the application of the rules where the maturity of such payments may be accelerated (e.g., based on prepayments on home mortgages that collateralize the obligation).

Gain or loss on disposition or prepayment

In general, the sale or exchange of a debt obligation that is a capital asset results in the realization of a capital gain or loss to the seller. Under section 1271, amounts received by a holder of a debt obligation, other than one issued by an individual, on retirement of such debt obligation is treated as an amount received in exchange for the debt obligation. Thus, subject to certain exceptions discussed below, if a debt obligation not issued by an individual is a capital asset, its satisfaction, either at or in advance of its maturity, generally results in the realization of a capital gain or loss measured by the difference between the amount realized and the basis of the obligation. Since section 1271 does not apply to obligations issued by individuals, repayment of a debt obligation by an individual (including prepayment) is not treated as a sale or exchange, and thus may not give rise to capital gain or loss.[60]

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[58] Under proposed Treasury regulations, different accrual periods may be required. *See* Prop. Treas. Reg. sec. 1.1272-1(d).

[59] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually to the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender then is deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

Capital gain treatment also is unavailable if an obligation has original issue discount and, at the time of original issue, there was an intention to call the obligation before maturity. In general, in such a case, any gain realized on the sale or exchange (including retirement by the issuer) of the obligation is treated as ordinary income to the extent that the gain does not exceed the amount of unamortized original issue discount (sec. 1271(a)(2)). There is no authority that directly addresses the application of this provision to corporate debt obligations that are issued with original issue discount and that are called prior to maturity upon the prepayment of mortgages in a pool that collateralizes the debt obligation.

The market discount rules

The availability of capital gain treatment on the sale or exchange of a debt obligation also may be limited pursuant to the so-called "market discount" rules. In general, under the market discount rules (secs. 1276-1278), gain on the disposition of a debt obligation that was issued after July 18, 1984, generally is treated as interest income to the extent of accrued market discount. Market discount is defined as the excess of the stated redemption price of an obligation over its basis immediately after acquisition, (provided that such excess is not less than a certain *de minimis* amount). In the case of a bond that has original issue discount, for purposes of the market discount rules, its stated redemption price is treated as the sum of its issue price and the amount of original issue discount that would have been includible in the income of an original holder.

Accrued market discount on an obligation generally is the amount that bears the same ratio to the market discount on such obligation as the number of days the taxpayer holds the obligation bears to the number of days after the taxpayer acquired the obligation until its maturity (sec. 1276(b)(1)). However, the holder may elect to accrue the market discount on an obligation using a constant interest rate.[61] A holder also may elect to include accrued market discount in income annually (sec. 1278(b)). Under prior law, the method of allocating market discount among principal payments on an obligation where such principal is paid in multiple installments was uncertain.

If indebtedness is incurred to purchase or carry obligations that have market discount, interest on such indebtedness in excess of the amount of interest includible in income with respect to such obligation is deductible only to the extent that such interest exceeds the market discount allocable to the taxable year (sec. 1277). Any interest expense disallowed under this provision is allowable as a deduction in the year that the obligation is disposed of. This limitation on interest deductions is not imposed if the holder elects to include market discount in income currently.

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[60] *See* sec. 1271(b)(1). In addition, obligations issued before July 2, 1982, by an issuer other than a corporation or a government (or political subdivision thereof) do not qualify for capital gains treatment. *See* sec. 1271(b)(2).

[61] The constant interest rate method results in smaller amounts being treated as accrued market discount in the earlier years

The coupon stripping rules

The separation of ownership of the right to receive any payment of principal or interest on a debt obligation generally results in the application of the "coupon stripping" rules (sec. 1286). Under these rules, the holder of a debt obligation who disposes of the right to receive certain payments on the obligation, (other than a pro rata share of all payments), must allocate, (on the basis of fair market value), his basis in the obligation between the portion of the debt obligation that is disposed of and the portion retained, for purposes of recognizing gain or loss.

Following such a disposition, for purposes of the treatment of the holder, the retained portion is treated as a debt obligation having original issue discount equal to the excess of the amount that will be received upon payment of amounts due at maturity of such retained portion over the amount of basis allocated thereto. Similarly, a purchaser of the disposed of portion of the debt obligation is treated as having purchased a debt obligation having original issue discount equal to the excess of the amount payable upon maturity of such portion over the amount paid therefor. The original issue discount rules then govern the amount that the respective holders must include in income annually.

Withholding on interest paid to foreign taxpayers

In general, a 30-percent withholding tax is imposed on portfolio interest paid to foreign taxpayers (secs. 871, 881, 1441, and 1442).[62] However, the withholding tax is not imposed on interest paid on certain obligations issued after July 18, 1984 (secs. 871(h) and 882(c)). Although obligations issued by individuals generally are not eligible for the exception,[63] most mortgage-backed securities issued after July 18, 1985, are eligible for the exception.[64] This is true even if the mortgage-backed security is in the form of a participation certificate in a grantor trust, in which case, the holder is for all other purposes treated as holding a proportionate share of the underlying mortgages. In such a case, however, the withholding tax is applied to the extent that the underlying mortgages were issued on or before July 18, 1984.[65]

Other

Certain thrift institutions are permitted to deduct a percentage of their taxable income as a bad debt deduction provided that a specified portion of the institution's assets are "qualifying assets," including "qualifying real property loans" (secs. 593, 7701(a)(19)). Debt obligations that are secured by real property mortgage loans are not treated as qualifying real property loans.

Issuers of debt instruments that have original issue discount are required to report to certain holders, the amount of interest payments and the annual accrual of OID (sec. 6049).

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[62] A lower rate of tax may be imposed pursuant to a treaty.

[63] Temp. Treas. Reg. sec. 35a.9999-5(a) (Q & A 1).

[64] Temp. Treas. Reg. sec. 35a.9999-5(d) (Q & A 20).

[65] *Id.*

Reasons for Change

The Congress recognized the increasing extent to which real estate mortgages are traded on secondary markets and the increasing extent to which multiple-class arrangements are used in the "packaging" of mortgages. Further, the Congress understood that considerable uncertainty exists concerning several aspects of the Federal income tax treatment of these types of securities. Accordingly, the Congress wished to provide rules to clarify the treatment of such securities. The Congress believed that the best method for doing so is to provide a new type of vehicle for the issuance of such multiple class securities, and to provide rules that are as comprehensive as possible for the taxation of all transactions relating to the use of such vehicles.

The Congress believed that this vehicle should be the exclusive vehicle (accompanied by exclusive tax consequences) relating to the issuance of multiple class mortgage-backed securities, and that availability of other vehicles should be limited to the extent possible. Nevertheless, the Congress believed that the vehicle provided should be the exclusive vehicle only after a reasonable transition period. The purpose of this transition period is to enable Congress to ascertain whether the vehicle provided is an appropriate and serviceable one.

The Congress believed that there should be some relief from two levels of taxation (i.e., at the entity level and at the shareholder level) where an entity with multiple classes of interests holds only a pool of real estate mortgages and related assets, has no powers to vary the composition of its mortgage assets, and has other powers generally consistent with the preservation of trust status, provided that satisfactory rules are prescribed for the taxation of the multiple interests.[66]

The Congress believed that the new vehicle provided by the Act, since it is intended to be the exclusive one for the issuance of multiple class securities backed by real property mortgages, should be flexible enough to accommodate most legitimate business concerns while preserving the desired certainty of income tax treatment. Accordingly, the Congress believed that the provisions of the Act should apply to any multiple class entity used for packaging interests in mortgages, regardless of the legal form used, provided that the interests satisfy the specified substantive requirements.

Although the Congress believed that no separate corporate level tax should be imposed on a fixed pool of mortgages with multiple classes of interests, the Congress was nevertheless concerned that the provision of a flexible vehicle without the imposition of a separate corporate level tax could lead to certain systematic opportunities to avoid taxation on a portion of income derived from the pool of mortgages through the use of tax-exempt entities, foreign persons, and taxpayers with net operating loss carryovers. Accordingly, the Congress believed that to prevent such opportunities, a portion of the income from the pool of mortgages should be treated as unrelated business income for tax-exempt entities, as subject to the full statutory withholding rate for foreign persons, and should not be eligible to be offset by net operating losses. The Congress believed, however, that because of the hardship being experienced by the thrift industry, an exception should be made for net operating losses of thrift institutions.

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[66] In absence of the provision of adequate rules for the taxation of the various interests, the Congress believed that the treatment of multiple class trusts provided by Treas. Reg. sec. 301.7701-4(c) is an appropriate treatment of such entities.

The Congress recognized that, in order to measure income as accurately as possible, an essential feature of providing satisfactory rules for the taxation of the multiple classes of interests is the clarification of the application of the OID rules and related issues as applied to mortgages and mortgage-backed securities. Given the uncertainty created by the unknown timing of prepayments on mortgages, the Congress believed that the OID rules adopted by the Act provide a reasonable approximation of the economic accrual of income, recognizing that the amount of OID accrued in a particular accrual period under the Act, may be either greater or less than an the amount that would be accrued if there were perfect advance knowledge of the timing of prepayments.

Explanation of Provisions

Overview

In general, the Act provides rules relating to "real estate mortgage investment conduits" or "REMICs." In general, a REMIC is a fixed pool of mortgages with multiple classes of interests held by investors. The Act provides rules prescribing (1) the Federal income tax treatment of the REMIC, (2) the treatment of taxpayers who exchange mortgages for interests in the REMIC, (3) the treatment of taxpayers holding interests in the REMIC, and (4) the treatment of disposition of interests in the REMIC.

In general, if the specified requirements are met, the REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests therein, under specified rules. Holders of "regular interests" generally take into income that portion of the income of the REMIC that would be recognized by an accrual method holder of a debt instrument that had the same terms as the particular regular interest; holders of "residual interests" take into account all of the net income of the REMIC that is not taken into account by the holders of the regular interests. Rules are provided that (1) treat a portion of the income of the residual holder derived from the REMIC as unrelated business income for tax-exempt entities or as subject to withholding at the statutory rate when paid to foreign persons, and (2) prevent such portion from being offset by net operating losses, other than net operating losses of certain thrift institutions.

The Act also contains provisions relating to the application of the OID rules to certain debt instruments the timing of whose maturities is contingent upon the timing of payments on other debt instruments. In addition, the Act imposes certain new information reporting requirements.

Further, the Act treats as a corporation any entity or other arrangement, referred to as a "taxable mortgage pool," that is used primarily to hold mortgages, where maturities of debt instruments that are issued by the entity in multiple classes, are tied to the timing of payments on the mortgages.

Requirements for qualification as a REMIC

Under the Act, any entity, including a corporation, partnership, or trust, that meets specified requirements would be permitted to elect to be treated as a REMIC. In addition, a segregated pool of assets also may qualify as a REMIC as if it were an entity meeting the requirements. To elect REMIC status, requirements relating to the composition of assets and the nature of the investors' interests must be satisfied, and an election to be treated as a REMIC must be in effect for the taxable year, and if applicable, all prior taxable years.

The asset test

Under the Act, in order to qualify as a REMIC, substantially all of the assets of the entity or segregated pool, as of the close of the third calendar month beginning after the startup day and as of the close of every quarter of each calendar year thereafter, must consist of "qualified mortgages," and "permitted investments." The Congress intended that the term substantially all should be interpreted to allow the REMIC to hold only de minimis amounts of other assets.

A "qualified mortgage" is any obligation (including any participation or certificate of beneficial ownership interest therein) that is principally secured by an interest in real property, and that either (1) is transferred to the REMIC on or before the "startup day," or (2) is purchased by the REMIC within the three-month period beginning on the startup day.[67] A qualified mortgage also includes a "qualified replacement mortgage." A qualified replacement mortgage is any property that would have been treated as a qualified mortgage if it were transferred to the REMIC on or before the startup day, and that is received either (1) in exchange for a defective qualified mortgage[68] within a two year period beginning on the startup day, or (2) in exchange for any other qualified mortgage within a three month period beginning on the startup day. In addition, any regular interest in another REMIC that is transferred to the REMIC on or before the startup day is treated as a qualified mortgage. The startup day is any day selected by the REMIC that is on or before the first day on which interests in the REMIC are issued.

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[67] The Congress intended that stripped coupons and stripped bonds (within the meaning of sec. 1286) may be treated as qualifying mortgages if the bonds (within the meaning of sec. 1286) from which such stripped coupons or stripped bonds arose would have been qualified mortgages. The Congress also intended that interests in grantor trusts would be treated as qualified mortgages, to the extent that the assets of the trusts that holders of the beneficial interest therein are treated as owning, would be treated as qualifying mortgages. In addition, the Congress intended that interests in qualifying mortgages in the nature of the interests described in Treas. Reg. sec. 301.7701-4(c)(2)(Example 2), and loans principally secured by stock of a tenant-stockholder of a cooperative housing corporation would be treated as qualifying mortgages. Nevertheless, except for regular interests in a REMIC, Congress did not intend that debt obligations that are secured primarily by other debt obligations would be treated as qualified mortgages even where such other debt obligations are secured primarily by interests in real property. A technical correction may be necessary to reflect this intention.

[68] For this purpose, the Congress intended that a defective qualified mortgage generally would have the same meaning as that used for purposes of determining the ability of a grantor trust that holds mortgages to substitute those mortgages without losing its status as a grantor trust for Federal income tax purposes. Thus, for example, a defective qualified mortgage is a qualified mortgage with respect to which there is a default or threatened default by the obligor.

"Permitted investments" are "cash flow investments," "qualified reserve assets," and "foreclosure property."

"Cash flow investments" are any investment of amounts received under qualified mortgages for a temporary period before distribution to holders of interests in the REMIC. The Congress intended that these are assets that are received periodically by the REMIC, invested temporarily in passive-type assets, and paid out to the investors at the next succeeding regular payment date. The Congress intended that these temporary investments are to be limited to those types of investments that produce passive income in the nature of interest. For example, the Congress intended that an arrangement commonly known as a "guaranteed investment contract," whereby the REMIC agrees to turn over payments on qualified mortgages to a third party who agrees to return such amounts together with a specified return thereon at times coinciding with the times that payments are to be made to holders of regular or residual interests, may qualify as a permitted investment.

"Qualified reserve assets" are any intangible property held for investment that is part of a "qualified reserve fund." A qualified reserve fund is any reasonably required reserve that is maintained by the REMIC to provide for payments of certain expenses and to provide additional security for the payments due on regular interests in the REMIC that otherwise may be delayed or defaulted upon because of defaults (including late payments) on the qualified mortgages.[69] In determining whether the amount of the reserve is reasonable, the Congress believed that it is appropriate to take into account the creditworthiness of the qualified mortgages and the extent and nature of any guarantees relating to the qualified mortgages. Further, amounts in the reserve fund must be reduced promptly and appropriately as regular interests in the REMIC are retired.

Under the Act, a reserve is not treated as a qualified reserve unless for any taxable year (and all subsequent taxable years) not more than 30 percent of the gross income from the assets in such fund for the taxable year is derived from the sale or other disposition of property held for less than three months. For this purpose, gain on the disposition of a reserve fund asset is not taken into account if the disposition of such asset is required to prevent default on a regular interest where the threatened default resulted from a default on one or more qualified mortgages.

"Foreclosure property" is property that would be foreclosure property under section 856(e) if acquired by a real estate investment trust, and which is acquired by the REMIC in connection with the default or imminent default of a qualified mortgage. Property so acquired ceases to be foreclosure property one year after its acquisition by the REMIC.

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[69] Congress intended that property would not fail to be considered to be held for investment, solely because the REMIC holds the property for these reasons.

Investors' interests

In order to qualify as a REMIC under the Act, all of the interests in the REMIC must consist of one or more classes of "regular interests" and a single class of "residual interests."

Regular interests.—A regular interest in a REMIC is an interest in a REMIC whose terms are fixed on the startup day, which terms (1) unconditionally entitle the holder to receive a specified principal (or similar) amount, and (2) provide that interest (or similar) payments, if any, at or before maturity are based on a fixed rate (or to the extent provided in Treasury regulations, a variable rate). An interest in the REMIC may qualify as a regular interest where the timing (but not the amount) of the principal (or similar) payments are contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments.

The Congress intended that regular interests in REMICs may be issued in the form of debt, stock, partnership interests, interests in a trust, or any other form permitted by state law. Thus, if an interest in a REMIC is not in the form of debt, the Congress understood that the interest would not have a specified principal amount, but that the interest would qualify as a regular interest if there is a specified amount that could be identified as the principal amount if the interest were in the form of debt. For example, an interest in a partnership could qualify as a regular interest if the holder of the partnership interest were to receive a specified amount in redemption of the partnership interest, and that the amount of income allocated to such partnership interest were based on a fixed percentage of the specified outstanding redemption amount.

The Congress intended that an interest in a REMIC would not fail to be treated as a regular interest if the payments of principal or interest (or similar) amounts with respect to such interest are subordinated to payments on other regular interests in the REMIC in the event of defaults on qualified mortgages. Thus, the Congress intended that regular interests in a REMIC may resemble the types of interests described in Treas. Reg. sec. 301.7701-4(c)(2)(Example 2).[70]

The Congress intended that an interest in a REMIC may not qualify as a regular interest if the amount of interest (or similar payments) is disproportionately high relative to the specified principal amount. For example, if an interest is issued in the form of debt with a coupon rate of interest that is substantially in excess of prevailing market interest rates (adjusted for risk), the Congress intended that the interest would not qualify as a regular interest. Instead, the Congress intended that such an interest may be treated either as a residual interest, or as a combination of a regular interest and a residual interest. Congress intended that interests issued at a discount may qualify as a regular interests.

Residual interests.—In general, a residual interest in a REMIC is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest, and that all distributions (if any) with respect to such interests are pro rata. For example, the residual interest in a mortgage pool that otherwise qualifies as a REMIC is held by two taxpayers, one of whom has a 25 percent interest in the residual and the other of whom has a 75 percent interest. Except for their relative size, the interests of the two taxpayers are identical. Provided that all distributions to the residual interest holders are pro rata, the mortgage pool would qualify as a REMIC because there is only one class of residual interest. If, however, the holder of the 25 percent interest is entitled to receive all distributions to which residual holders combined are entitled for a specified period (or up to a specified amount) in return for the surrender of his interest, then the mortgage pool would be considered to have two classes of residual interests and would not qualify as a REMIC.

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[70] The status of an interest as a regular interest in this case does not depend on whether the subordinated regular interest is sold or retained.

The Congress intended that an interest in a REMIC could qualify as a residual interest regardless of its value. Thus, for example, an interest need not entitle the holder to any distributions in order to qualify as a residual interest. Nevertheless, the treatment of a holder of a residual interest may depend on the value of the residual interest relative to all of the interests in a REMIC.[71]

Where the REMIC's qualified mortgages are stripped coupons or stripped bonds (within the meaning of section 1286), Congress did not intend that any other stripped coupons or stripped bonds arising from the same debt instruments as the qualified mortgages would be treated as a second class of residual interest in the REMIC. In addition, the Congress intended that the right to receive payment from the REMIC for goods or services rendered in the ordinary operation of the REMIC would not be considered to be an interest in the REMIC for these purposes.

Inadvertent terminations

The Act provides regulatory authority to the Treasury Department to issue regulations that address situations where failure to meet one or more of the requirements for REMIC status occurs inadvertently, and disqualification of the REMIC would occur absent regulatory relief. The Congress anticipated that the Treasury regulations would provide relief only where the failure to meet any of the requirements occurred inadvertently and in good faith. The Congress also intended that the relief may be accompanied by appropriate sanctions, such as the imposition of a corporate tax on all or a portion of the REMIC's income for the period of time in which the requirements are not met.

Formation of the REMIC

Under the Act, no gain or loss is recognized to the transferor upon the transfer of property to a REMIC in exchange for regular or residual interests in the REMIC. Upon such a transfer, the adjusted bases of the regular or residual interests received in the transaction are to be equal in the aggregate to the aggregate of the adjusted bases of the property transferred. The aggregate basis of the interests received is allocated among the regular or residual interests received in proportion to their fair market values.[72] The basis of any property received by a REMIC in exchange for regular or residual interests in the REMIC is equal to the aggregate fair market value of the regular or residual interests at the time of transfer (or earlier time provided by Treasury regulations).[73]

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[71] *See* text accompanying nn. 84–87, *infra*.

The Congress intended that any properly allocable costs of acquiring the regular or residual interests would be capitalized and added to the basis of the regular or residual interest. Upon a subsequent sale or exchange of any regular or residual interest, gain or loss is recognized.

The Congress intended that the Federal income tax consequences of forming a REMIC should be the same regardless of whether regular and or residual interests were issued in exchange for qualified mortgages and followed by a sale of some or all of the interests issued, or whether such interests were issued for cash or other property and followed by a purchase of qualified mortgages. The Congress expected that the step transaction doctrine would be applied so that the formation of a REMIC in the latter fashion would be recharacterized as a contribution of mortgages to the REMIC in exchange for regular and residual interests followed by a sale of all or a portion of those interests by the transferor of the mortgages.[74]

In the case of a REMIC that is not formed as a separate entity, but rather as a segregated pool of assets, the Congress intended that the transfer is deemed to occur and the REMIC is deemed to be formed only upon the issuance of regular and residual interests therein.

Federal income tax treatment of the REMIC

Pass-through status

In general, the Act provides that a REMIC is not a taxable entity for Federal income tax purposes. The income of the REMIC generally is taken into account by holders of regular and residual interests in the REMIC as described below. Nevertheless, the REMIC is subject to tax on prohibited transactions, and may be required to withhold on amounts paid to foreign holders of regular or residual interests.[75]

The pass-through status of the REMIC provided by the Act applies regardless of whether the REMIC otherwise would be treated as a corporation, partnership, trust, or any other entity. The Congress intended that where the requirements for REMIC status are met, that the exclusive set of rules for the treatment of all transactions relating to the REMIC and of holders of interests therein are to be those set forth in the provisions of the Act. Thus, for example, in the case of a REMIC that would be treated as a partnership if it were not otherwise a REMIC, the provisions of subchapter K of the Code would not be applicable to any transactions involving the REMIC or any of the holders of regular or residual interests.[76]

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[72] The Congress intended that a holder of a mortgage should not be permitted to recognize loss where mortgages are indirectly transferred to a REMIC. Thus, the Congress intended that no gain or loss would be recognized, for example, if pursuant to a plan, mortgages are sold by one taxpayer to another, and the buyer transfers the purchased mortgages to a REMIC in which interests are purchased by the initial seller of the mortgages.

[73] The Congress intended that the Treasury regulations may provide that the basis of qualified mortgages held by the REMIC in certain circumstances may be determined based on the fair market value of such mortgages at a reasonable time prior to transfer to the REMIC where such mortgages were purchased by the transferor solely for the purpose of transfer to the REMIC.

[74] Thus, for example, if a REMIC is formed by issuing regular and residual interests for cash and the REMIC subsequently purchases qualified mortgages from a holder of a residual interest, such holder would be treated as transferring the qualified mortgages to the REMIC in exchange for regular and residual interests and then having sold all the interests other than those held at the time of the sale. Moreover, the allocation of basis between the regular and residual interests should reflect the relative fair market values of such interests as if the formation had actually taken place by transferring mortgages in exchange for the regular and residual interests.

[75] Withholding also may be required with respect to certain amounts without actual payment to foreign holders, however. See text accompanying nn. 86–87, *infra*.

Prohibited transactions

Under the Act, a REMIC is required to pay a tax equal to 100 percent of the REMIC's net income from prohibited transactions. For this purpose, net income from prohibited transactions is computed without taking into account any losses from prohibited transactions or any deductions relating to prohibited transactions that result in a loss. Prohibited transactions for the REMIC include the disposition of any qualified mortgage other than pursuant to (1) the substitution of a qualified replacement mortgage for a defective qualified mortgage, (2) the bankruptcy or insolvency of the REMIC, (3) a disposition incident to the foreclosure, default, or imminent default of the mortgage, or (4) a qualified liquidation (described below). In addition, the disposition of a qualified mortgage is not a prohibited transaction if such disposition is required to prevent default on a regular interest where such default on the regular interest is threatened on account of a default on one or more qualified mortgages. Other prohibited transactions include the disposition of any cash flow investment other than pursuant to a qualified liquidation, the receipt of any income from assets other than assets permitted to be held by the REMIC, and the receipt of any compensation for services.[77]

Taxation of the holders of regular interests

In general

Under the Act, holders of regular interests generally are taxed as if their regular interest were a debt instrument to which the rules of taxation generally applicable to debt instruments apply, except that the holder of a regular interest is required to account for income relating to such interest on the accrual method of accounting regardless of the method of accounting otherwise used by the holder.[78] In the case of regular interests that are not debt instruments, the amount of the fixed unconditional payment is treated as the stated principal amount of the instrument, and the periodic payments (i.e., the amounts that are based on the amount of the fixed unconditional payment), if any, are treated as stated interest payments. In other words, generally consistent with the pass-through nature of the REMIC, the holders of regular interests generally take into account that portion of the REMIC's income that would be taken into account by an accrual method holder of a debt instrument with terms equivalent to the terms of the regular interest.[79]

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[76] For purposes of subtitle F of the Code (relating to certain administrative matters) the REMIC is treated as a partnership in which residual interests are the partnership interests, however. The Congress intended that the initial election of REMIC status is to be made on the first partnership information return that the REMIC is required to file.

[77] The Congress intended that payment by the obligor on a debt instrument is not to be considered to be a disposition of such debt instrument for these purposes.

[78] The Congress intended that periodic payments of interest (or similar amounts) are to be treated as accruing pro rata between the dates that such interest (or similar amounts) is paid.

The Congress intended that regular interests are to be treated as if they were debt instruments for all other purposes of the Internal Revenue Code. Thus, for example, regular interests would be treated as market discount bonds, where the revised issue price (within the meaning of section 1278) of the regular interest exceeds the holder's basis in the interest. Moreover, the Congress intended that the REMIC is subject to the reporting requirements of section 1275 with respect to the regular interests. In addition, the Congress intended that regular interests are to be treated as evidences of indebtedness under section 582(c)(1), so that gain or loss from the sale or exchange of regular interests by certain financial institutions would not be treated as gain or loss from the sale or exchange of a capital asset. In addition, any market premium on a regular interest could be amortized currently under section 171.

The issue price of regular interests in the REMIC are determined under the rules of section 1273(b). In the case of regular interests issued in exchange for property, however, the issue price of the regular interest is equal to the fair market value of the property,[80] regardless of whether the requirements of section 1273(b)(3) are met. A holder's basis in the regular interest generally is equal to the holder's cost therefor, but in the case of holders who received their interests in exchange for property, then as discussed above, the holder's basis is equal to the basis of the property exchanged for the REMIC interest. Where property is transferred in exchange for more than one class of regular or residual interest, the basis of the property transferred is allocated in proportion to the fair market value of the interests received.

Regular interests received in exchange for property

Under the Act, where an exchange of property for regular interests in a REMIC has taken place, any excess of the issue price of the regular interest over the basis of the interest in the hands of the transferor immediately after the transfer is, for periods during which such interest is held by the transferor (or any other person whose basis is determined in whole or in part by reference to the basis of such interest in the hands of the transferor), includible currently in the gross income of the holder under rules similar to the rules of section 1276(b) (i.e., the holder of such an interest is treated like the holder of a market discount bond for which an election under section 1278(b) is in effect). Conversely, the excess of the basis of the regular interest in the hands of the transferor immediately after the transfer over the issue price of the interest is treated for such holders as market premium that is allowable as a deduction under rules similar to the rules of section 171. The Congress intended that the holder's basis in the regular interest would be properly adjusted to reflect such current inclusions or deductions.

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[79] In the event that the amount so determined exceeds the income of the REMIC, however, there is no diminution of the required inclusions for such holders.

[80] For this purpose, the Congress intended that the fair market value of the property is to be determined by reference to the fair market value of the regular interests received in exchange.

Disposition of regular interests

The Act treats gain on the disposition of a regular interest as ordinary income to the extent of a portion of unaccrued OID with respect to the interest. Such portion generally is the amount of unaccrued OID equal to the excess, if any, of the amount that would have been includible in the gross income of the taxpayer with respect to such interest if the yield on such interest were 110 percent of the applicable Federal rate (as defined in sec. 1274(d) without regard to paragraph (2) thereof) determined as of the time that the interest is acquired by the taxpayer, over the total amount of ordinary income includible by the taxpayer with respect to such regular interest prior to disposition. In selecting the applicable Federal rate, the Congress intended that the same prepayment assumptions that are used in calculating OID are to be used in determining the maturity of the regular interest.

Taxation of the holders of residual interests

In general

In general, the Act provides that at the end of each calendar quarter, the holder of a residual interest in a REMIC takes into account his daily portion of the taxable income or net loss of the REMIC for each day during the holder's taxable year in which such holder held such interest. The amount so taken into account is treated as ordinary income or loss. The daily portion for this purpose is determined by allocating to each day in any calendar quarter a ratable portion of the taxable income or net loss of the REMIC for such quarter, and by allocating the amounts so allocated to any day among the holders (on such day) of residual interests in proportion to their respective holdings on such day.

For example, a REMIC's taxable income for a calendar quarter (determined as described below) is $1,000. There are two holders of residual interests in the REMIC. One holder of 60 percent of the residual holds such interest for the entire calendar quarter. Another holder has a 40 percent interest, and transfers the interest after exactly one half of the calendar quarter to another taxpayer. As of the end of the calendar quarter, the holder of the sixty percent interest would be treated as receiving $600 ratably over the quarter. Each holder of the 40 percent interest would be treated as receiving $200 ratably over the portion of the quarter in which the interest was held.

Distributions from the REMIC are not included in the gross income of the residual holder to the extent that such distributions do not exceed the adjusted basis of the interest. To the extent that distributions exceed the adjusted basis of the interest, the excess is treated as gain from the sale of the residual interest. Residual interests are treated as evidences of indebtedness for purposes of section 582(c).

The amount of any net loss of the REMIC that may be taken into account by the holder of a residual interest is limited to the adjusted basis of the interest as of the close of the quarter (or time of disposition of the interest if earlier), determined without taking into account the net loss for the quarter. Any loss that is disallowed on account of this limitation may be carried over indefinitely by the holder of the interest for whom such loss was disallowed and may be used by such holder only to offset any income generated by the same REMIC.

Except for adjustments arising from the nonrecognition of gain or loss on the transfer of mortgages to the REMIC (discussed below), the holders of residual interests take no amounts into account other than those allocated from the REMIC.[81]

Determination of REMIC taxable income or net loss

In general, under the Act, the taxable income or net loss of the REMIC for purposes of determining the amounts taken into account by holders of residual interests, is determined in the same manner as for an individual having the calendar year as his taxable year and using the accrual method of accounting, with certain modifications. The first modification is that a deduction is allowed with respect to those amounts that would be deductible as interest if the regular interests in the REMIC were treated as indebtedness of the REMIC. Second, in computing the gross income of the REMIC, market discount with respect to any market discount bond (within the meaning of sec. 1278) held by the REMIC is includible for the year in which such discount accrues, as determined under the rules of section 1276(b)(2), and sections 1276(a) and 1277 do not apply. Third, no item of income, gain, loss, or deduction allocable to a prohibited transaction is taken into account. Fourth, deductions under section 703(a)(2) (other than deductions allowable under section 212) are not allowed.[82]

If a REMIC distributes property with respect to any regular or residual interest, the REMIC recognizes gain in the same manner as if the REMIC had sold the property to such distributee at its fair market value. The Congress intended that the distribution is to be treated as an actual sale by the REMIC for purposes of applying the prohibited transaction rules and the rules relating to qualified reserve funds. The basis of the distributed property in the hands of the distributee is then the fair market value of the property.

Adjusted basis of residual interests

Under the Act, a holder's basis in a residual interest in a REMIC is increased by the amount of the taxable income of the REMIC that is taken into account by the holder. The basis of such an interest is decreased (but not below zero) by the amount of any distributions received from the REMIC and by the amount of any net loss of the REMIC that is taken into account by the holder. In the case of a holder who disposes of a residual interest, the basis adjustment on account of the holder's daily portions of the REMIC's taxable income or net loss is deemed to occur immediately before the disposition.

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[81] The Congress understood that the taxable income allocated to holders of residual interests in a REMIC who purchased such interests from a prior holder after a significant change in value of the interest, could be substantially accelerated or deferred on account of any premium or discount in the price paid by such purchaser. Accordingly, the Congress recognized that certain modifications of the rules governing taxation of holders of residual interests may be appropriate where the method of taxation of holders of residual interests prescribed by the Act has such consequences.

[82] The Congress intended that no gain or loss is recognized to the REMIC on the exchange of regular or residual interests in the REMIC for property. In addition, the Congress understood that the treatment of deductions allowable under section 212 will be addressed in Treasury regulations. In this regard, the Congress intended that such deductions would be allocated to all holders of interests in REMICs that are similar to single-class grantor trusts under present law. However, the Congress intended that such deductions would be allocated to the holders of the residual interests in the case of other REMICs.

Special treatment of a portion of residual income

Under the Act, a portion of the net income of the REMIC taken into account by the holders of the residual interests may not be offset by any net operating losses of the holder. The Act provides a special exception from this rule in the case of certain thrift institutions, on account of the difficulties currently being experienced by the thrift industry.

In addition, the Act provides that the same portion of the net income of the REMIC that may not be offset by net operating losses, is treated as unrelated business income for any organization subject to the unrelated business income tax under section 511, and is not eligible for any reduction in the rate of withholding tax (by treaty or otherwise) in the case of a nonresident alien holder.

The portion of the income of the residual holder that is subject to these rules is the excess, if any, of the amount of the net income of the REMIC that the holder takes into account for any calendar quarter, over the sum of the daily accruals with respect to such interest while held by such holder. The daily accrual for any residual interest for any day in any calendar quarter is determined by allocating to each day in such calendar quarter a ratable portion of the product of the adjusted issue price of the residual interest at the beginning of such accrual period, and 120 percent of the long-term Federal rate. The long-term Federal rate used for this purpose is the Federal long-term rate that would have applied to the residual interest under section 1274(d) (without regard to section 1274(d)(2)) if it were a debt instrument, determined at the time that the residual interest is issued. The rate is adjusted appropriately in order to be applied on the basis of compounding at the end of each quarter.

For this purpose (and for purposes of the treatment of gain or loss that is not recognized upon the transfer of property to a REMIC in exchange for a residual interest, as discussed below), the residual interest is treated as having an issue price that is equal to the amount of money paid for the interest at the time it is issued, or in the case of a residual interest that is issued in exchange for property, the fair market value of the interest at the time it is issued. The adjusted issue price of the residual interest is equal to the issue price of the interest increased by the amount of daily accruals for prior calendar quarters, and decreased (but not below zero) by the amount of any distributions with respect to the residual interest prior to the end of the calendar quarter.

In addition, the Act provides that under Treasury regulations, if a REIT owns a residual interest in a REMIC, a portion of dividends paid by the REIT would be treated as excess inclusions for REIT shareholders. Thus, such income generally could not be offset by net operating losses, would constitute unrelated business taxable income for tax-exempt holders, and would not be eligible for and reduction in the rate of withholding tax in the case of a nonresident alien holder.

The Act provides that to the extent provided in Treasury regulations, in the case of a residual interest that does not have significant value, the entire amount of income that is taken into account by the holder of the residual interest is treated as unrelated business income and is subject to withholding at the statutory rate. In addition, in the case of such a residual, income allocated to the holder thereof may not be offset by any net operating losses, regardless of who holds the interest.[83] The Congress intended that the Treasury regulations would take into account the value of the residual interest in relation to the regular interests, and that the Treasury regulations would not apply in cases where the value of the residual interest is at least two percent of the combined value of the regular and residual interests.[84]

The Act provides that the partnership information return filed by the REMIC is to supply information relating to the daily accruals of the REMIC.

Treatment of foreign residual holders

The Act provides that in the case of a holder of a residual interest of a REMIC who is a nonresident alien individual or foreign corporation, then for purposes of sections 871(a), 881, 1441, and 1442, amounts includible in the gross income of such holder with respect to the residual interest are taken into account only when paid or otherwise distributed (or when the interest is disposed of).[85] The Act also provides that under Treasury regulations, the amounts includible may be taken into account earlier than otherwise provided where necessary to prevent avoidance of tax. The Congress intended that this regulatory authority may be exercised where the residual interest in the REMIC does not have significant value (as described above).[86]

Residual interests received in exchange for property

In the case of a residual interest that is received in exchange for a contribution of property to the REMIC, any excess of the issue price of the residual interest over the basis of the interest in the hands of the transferor of the property immediately after the transfer, is amortized and is included in the residual holder's income on a straight line basis over the expected life of the REMIC. Similarly, any excess of the transferor's basis in the residual interest over the issue price of the interest is deductible by the holder of the interest on a straight line basis over the expected life of the REMIC. In determining the expected life of the REMIC for this purpose, the Congress intended that the assumptions used in calculating original issue discount and any binding agreement regarding liquidation of the REMIC are to be taken into account. The Congress intended that the holder's basis in the residual interest would be properly adjusted to reflect such current inclusions or deductions.

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[83] *I.e.*, the exception provided for thrift institutions in section 860E(a)(2) would not be available in these circumstances.

[84] The Congress intended that these regulations may apply in appropriate cases to residual interests issued before regulations are issued.

[85] The Congress intended that withholding upon disposition of such interests is to be similar to withholding upon disposition of debt instruments that have original issue discount.

[86] The Congress intended that these regulations may apply in appropriate cases to residual interests issued before regulations are issued.

Dispositions of residual interests

The Act provides that, except as provided in Treasury regulations, the wash sale rules of section 1091 apply to dispositions of residual interests in a REMIC where the seller of the interest, during the period beginning six months before the sale or disposition of the residual interest and ending six months after such sale or disposition, acquires (or enters into any other transaction that results in the application of section 1091) any residual interest in any REMIC or any interest in a "taxable mortgage pool" (discussed below) that is comparable to a residual interest.

Qualified liquidation

Under the Act, a qualified liquidation is a transaction in which the REMIC adopts a plan of complete liquidation, and sells all of its assets (other than cash) within the 90-day period beginning immediately after the date of the adoption of the plan of liquidation, provided that the REMIC distributes or otherwise credits in liquidation all of the sale proceeds plus its cash (other than amounts retained to meet claims) to holders of regular and residual interests within the 90-day period.[87] A holder of a regular or residual interest recognizes gain or loss on the liquidation of the REMIC. Sales of the REMICs assets pursuant to a qualified liquidation are not treated as prohibited transactions.[88]

Other provisions

Compliance provisions

The application of the OID rules contemplated by the Act requires calculations that are based on information that would not necessarily be known by any holder, and is more readily available to the issuer than any other person. Accordingly, the Act requires broader reporting of interest payments and OID accrual by the REMIC, or any issuer of debt that is subject to the OID rules of the Act. The Act specifies that the amounts includible in gross income of the holder of a regular interest in a REMIC are treated as interest for purposes of the reporting requirements of the Code (sec. 6049), and that the REMIC or similar issuer is required to report interest and OID to a broader group of holders than required under prior law. The holders to whom such broader reporting is required include corporations, certain dealers in commodities or securities, real estate investment trusts, common trust funds, and certain other trusts. In addition to reporting interest and OID, the REMIC or similar issuer is required to report sufficient information to allow holders to compute the accrual of any market discount or amortization of any premium in accordance with provisions of the Act.[89]

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[87] The Congress intended that the treatment of a holder to whom amounts merely are credited would be the same as if amounts actually were distributed.

[88] *See* discussion of prohibited transactions, above.

Treatment of REMIC interests for certain financial institutions and real estate investment trusts

Under the Act, regular and residual interests are treated as qualifying assets for purposes of section 593(d)(1) and section 7701(a)(19), in the same proportion that the assets of the REMIC would be treated as qualifying under those sections.[90] In the case of residual interests, the Congress intended that the amount treated as a qualifying asset not exceed the adjusted basis of the residual interest in the hands of the holder. Both regular and residual interests are treated as real estate assets under section 856(c)(6), and the income from such interests are treated as interest qualifying under section 856(c)(3)(C),[91] in the same proportion that the assets of the REMIC would be treated as real estate assets for purposes of determining eligibility for real estate investment trust status.[92]

Foreign withholding

The Congress intended that for purposes of withholding on interest paid to foreign persons, regular interests in REMICs should be considered to be debt instruments that are issued after July 18, 1984, regardless of the time that any debt instruments held by the REMIC were issued. The Congress intended that amounts paid to foreign persons with respect to residual interests should be considered to be interest for purposes of applying the withholding rules.

OID rules

The Act provides rules relating to the application of the OID rules to debt instruments that, as is generally the case with regular interests in a REMIC, have a maturity that is initially fixed, but that is accelerated based on prepayments on other debt obligations securing the debt instrument (or, to the extent provided in Treasury regulations, by reason of other events). The OID rules provided by the Act also apply to OID on qualified mortgages held by a REMIC.

In general, the OID rules provided by the Act require OID for an accrual period to be calculated and included in the holder's income based on the increase in the present value of remaining payments on the debt instrument, taking into account payments includible in the instrument's stated redemption price at maturity received on the regular interest during the period. For this purpose, the present value calculation is made at the beginning of each accrual period (1) using the yield to maturity determined for the instrument at the time of its issuance (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period), calculated on the assumption that, as prescribed by Treasury regulations, certain prepayments will occur, and (2) taking into account any prepayments that have occurred before the close of the accrual period.

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[89] *See* sec. 1803(a)(13) of the Act.

[90] If 95 percent of the assets of the REMIC would be treated as qualifying assets at all times during a calendar year then the entire regular or residual interest is so treated for the calendar year.

[91] A technical correction may be necessary to clarify the treatment of income from a REMIC taken into account by a REIT.

[92] If 95 percent of the assets of the REMIC would be treated as real estate assets at all times during a calendar year, then the entire regular or residual is so treated for the calendar year.

The Congress intended that the Treasury regulations will provide that the prepayment assumption to be used in calculating present values as of the close of each accrual period, and in computing the yield to maturity used in the calculation of such present values, will be that used by the parties in pricing the particular transaction. The Congress intended that such prepayment assumption will be determined by the assumed rate of prepayments on qualified mortgages held by the REMIC and also the assumed rate of earnings on the temporary investment of payments on such mortgages insofar as such rate of earnings would affect the timing of payments on regular interests.[93]

The Congress intended that the Treasury regulations will require these pricing assumptions to be specified in the first partnership return filed by the REMIC. In addition, the Congress intended that appropriate supporting documentation relating to the selection of the prepayment assumption must be supplied to the Internal Revenue Service with such return. Further, the Congress intended that the prepayment assumptions used must not be unreasonable based on comparable transactions, if comparable transactions exist.[94]

The Congress intended that unless otherwise provided by Treasury regulations, the use of a prepayment assumption based on a recognized industry standard would be permitted. For example, the Congress understood that prepayment assumptions based on a Public Securities Association standard currently is such an industry recognized standard.

The Congress intended that in no circumstances, would the method of accruing OID prescribed by the Act allow for negative amounts of OID to be attributed to any accrual period. If the use of the present value computations prescribed by the Act produce such a result for an accrual period, the Congress intended that the amount of OID attributable to such accrual period would be treated as zero, and the computation of OID for the following accrual period would be made as if such following accrual period and the preceding accrual period were a single accrual period.

Regulatory authority

The Act grants the Treasury Department authority to prescribe such regulations as are necessary or appropriate to implement the provisions relating to REMICs. The Congress expected that, among other things, such regulations will prevent unreasonable accumulations of assets in the REMIC, and require the REMIC to report information adequate to allow residual holders to compute taxable income accurately (including reporting more frequently than annually). Further, such regulations may require reporting of OID accrual more frequently than otherwise required by the Act.

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[93] In computing the accrual of OID (or market discount) on qualified mortgages held by the REMIC, only assumptions about the rate of prepayments on such mortgages would be taken into account.

[94] The Congress intended that in the case of publicly offered instruments, a prepayment assumption will be treated as unreasonable only in the presence of clear and convincing evidence. In addition, the Congress intended that in determining whether a prepayment assumption is reasonable, the nature of the debt instruments on which prepayments are being assumed, and the availability of information about prepayments thereon, will be taken into account. Thus, for example, under currently prevailing conditions, the Congress understood that there should be less tolerance in the evaluation of prepayment assumptions relating to pools of home mortgages than prepayment assumptions relating to pools of commercial mortgages.

Treasury study

The Congress was concerned about the impact of the REMIC provisions upon the thrift industry. Accordingly, the Act requests that the Treasury Department conduct a study of the effectiveness of the REMIC provisions in enhancing the efficiency of the secondary market in mortgages, and the impact of these provisions upon thrift institutions.

Taxable mortgage pools

The Congress intended that REMICs are to be the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of taxation. Thus, the Act provides that a "taxable mortgage pool" ("TMP") is treated as a taxable corporation that is not an includible corporation for purposes of filing consolidated returns.

Under the Act, a TMP is any entity other than a REMIC if (1) substantially all of the assets of the entity consist of debt obligations (or interests in debt obligations) and more than 50 percent of such obligations (or interests) consist of real estate mortgages, (2) such entity is the obligor under debt obligations with two or more maturities,[95] and (3) under the terms of such debt obligations on which the entity is the obligor, payment on such debt obligations bear a relationship to payments on the debt obligations (or interests therein) held by the entity.[96]

Under the Act, any portion of an entity that meets the definition of a TMP is treated as a TMP. For example, if an entity segregates mortgages in some fashion and issues debt obligations in two or more maturities, which maturities depend upon the timing of payments on the mortgages, then the mortgages and the debt would be treated as a TMP, and hence as a separate corporation. The TMP provisions are intended to apply to any arrangement under which mortgages are segregated from a debtor's business activities (if any) for the benefit of creditors whose loans are of varying maturities.

The Act provides that no domestic building and loan association (or portion thereof) is to be treated as a TMP.

Special rule for REITs

The Congress intended that an entity that otherwise would be treated as a TMP may, if it otherwise meets applicable requirements, elect to be treated as a REIT. If so, the Act provides that under Treasury regulations, a portion of the REIT's income would be treated in the same manner as income subject to the special rules provided for a portion of the income of a residual interest in a REMIC. The Congress intended that this calculation is to be made as if the equity interests in the REIT were the residual interest in a REMIC and such interests were issued (i.e., the issue price of interests is determined) as of the time that the REIT becomes a TMP.[97]

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[95] For this purpose, the Congress intended that debt instruments that may have the same stated maturity but different rights relating to acceleration of that maturity, are to be treated as having different maturities. In addition, the Act provides that to the extent provided in Treasury regulations, equity interests of varying classes that correspond to differing maturity classes of debt are to be treated as debt for these purposes.

[96] For example, certain arrangements that are commonly known as "Owners' Trusts" would be treated as TMPs under the Act.

The Congress intended that the Treasury regulations would provide that dividends paid to the shareholders of a REIT would be subject to the same rules provided for a portion of the income of holders of residual interests in a REMIC. Thus, for example, the Congress intended that the Treasury regulations would provide that to the extent that dividends from the REIT exceed the daily accruals for the REIT (determined in the same manner as if the REIT were a REMIC) such dividends (1) may not be offset by net operating losses (except those of certain thrift institutions[98]), (2) are treated as unrelated business income for certain tax-exempt institutions, and (3) are not eligible for any reduction in the rate of withholding when paid to foreign persons. The Congress also intended that the Treasury regulations would require a REIT to report such amounts to its shareholders.[99]

Effective Date

The provisions of the Act are effective with respect to taxable years beginning after December 31, 1986.[100] The amendments made by the Act to the OID rules apply to debt instruments issued after December 31, 1986. The provisions relating to taxable mortgage pools do not apply to any entity in existence on December 31, 1991, unless there is a substantial transfer of cash or property to such entity (other than in payment of obligations held by the entity) after such date. For purposes of applying the wash sale rules provided by the Act, however, the definition of a TMP is applicable to any interest in any entity in existence on or after January 1, 1987.

Revenue Effect

The provisions are estimated to decrease fiscal budget receipts by $5 million in 1987, $17 million in 1988, $36 million in 1989, $59 million in 1990, and $79 million in 1991.

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[97] If a portion of a REIT is treated as a TMP, such portion may qualify as a REIT subsidiary (see sec. 662 of the Act).

[98] *But see* section 860E(a)(2).

[99] If the REIT has a REIT subsidiary that is a TMP, then the Congress intended that the portion of the REIT's income that is subject to the special rules is determined based on calculations made at the level of the REIT subsidiary.

[100] The Congress intended that in the case of REMICs issued after December 31, 1986, such REMICs and the holders of interests therein would be governed by the provisions of the Act regardless of the taxable years of the holders.

TITLE VII—MINIMUM TAX PROVISIONS

Minimum Tax on Corporations and Individuals (Secs. 701–702 of the Act and secs. 53 and 55–59 of the Code)[1]

Prior Law

Corporate minimum tax

Under prior law, corporations paid a minimum tax on certain tax preferences. The tax was in addition to the corporation's regular tax. The amount of the minimum tax was 15 percent of the corporation's tax preferences, to the extent that the aggregate amount of these preferences exceeded the greater of the regular income tax paid or $10,000 (Code sec. 56).

Tax preference items

The tax preference items included in the base for the minimum tax for corporations were:

(1) For real property, the excess of accelerated over straight-line depreciation, applying the useful life or recovery period prescribed for regular tax purposes (in the case of property eligible for ACRS, 19 years);

(2) For certified pollution control facilities, the excess of 60-month amortization over the amount of depreciation otherwise allowable;

(3) In the case of certain financial institutions, the excess of the bad debt deductions over the amount of those deductions computed on the basis of actual experience;

(4) Percentage depletion to the extent in excess of the adjusted basis of the property; and

(5) 18/46 of the corporation's net capital gain.

For personal holding companies, accelerated depreciation on leased personal property, mining exploration and development costs, circulation expenditures, research and experimental expenditures, and excess intangible drilling costs were also preferences.

When a corporation had a regular tax net operating loss attributable to minimum tax preference items in excess of $10,000, no immediate add-on minimum tax liability was incurred with respect to those preference items. Minimum tax liability was incurred with respect to those preference items when the "preferential" portion of the net operating loss was used to offset regular taxable income, treating this portion as used only after nonpreferential net operating losses had been exhausted.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 501; H.Rep. 99-426, pp. 302-328; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1101; S.Rep. 99-313, pp. 515-540; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 250-284 (Conference Report).

Cutback in certain preferences

In addition to imposing an add-on minimum tax, prior law (sec. 291) imposed a cutback in the use of certain corporate tax preferences for regular tax purposes. Adjustments were made to the corporate minimum tax to prevent the combination of that tax and the cutback provision from unduly reducing the tax benefit from a preference. The cutback applied, with differing percentage reductions, to the following items: (1) certain excess depletion for coal and iron ore, (2) the portion of bad debt reserves deducted by financial institutions that exceeded deductions allowable under the experience method, (3) certain interest deductions of financial institutions that were allocable to purchasing or holding certain tax-exempt obligations, (4) a foreign sales corporation's (FSC) exempt foreign trade income, (5) the reduction of recapture, under section 1250, for depreciation deductions relating to real estate, (6) for pollution control facilities, the excess of the amortization deductions allowed over the depreciation deductions that would otherwise apply, (7) intangible drilling cost deductions of integrated oil companies, and (8) the expensing of mineral exploration and development costs.

Individual minimum tax

Under prior law, individuals were subject to an alternative minimum tax which was payable, in addition to all other tax liabilities, to the extent that it exceeded the individual's regular tax owed.[2] The tax was imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of the exemption amount. However, the amount so determined was reduced by the foreign tax credit and the refundable credits.

Alternative minimum taxable income generally was equal to regular tax adjusted gross income, as increased by certain tax preferences and decreased by the alternative tax itemized deductions. The exemption amount, which was subtracted from alternative minimum taxable income before applying the 20 percent rate, was $40,000 for joint returns, $20,000 for married individuals filing separately, and $30,000 for single returns.

Tax preference items

The tax preference items that were added to the adjusted gross income base for purposes of the alternative minimum tax on individuals were:

(1) Dividends excluded from gross income under section 116, which permitted individuals to exclude dividends received in an amount not to exceed $100 ($200 for a joint return);

(2) For real property, the excess of accelerated over straight-line depreciation, applying the useful life or recovery period prescribed for regular tax purposes (in the case of property eligible for ACRS, 19 years);

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[2] A taxpayer's regular tax meant the taxes imposed by chapter 1 of the Code (other than the alternative minimum tax, the investment credit recapture tax (sec. 47), the taxes applicable in some instances for annuities (sec. 72(m)(5)(B) and 72(q)), lump sum distributions from qualified pension plans (sec. 402(e)), individual retirement accounts (sec. 408(f)), and certain trust distributions (sec. 667(b)), reduced by all nonrefundable credits including the foreign tax credit.

(3) For leased personal property, the excess of accelerated depreciation over depreciation calculated under the straight-line method, with the latter being determined, in the case of property eligible for ACRS, by applying useful lives or recovery periods of five years for three-year property, eight years for five-year property, 15 years for 10-year property, and 22 years for 15-year public utility property;

(4) For certified pollution control facilities, the excess of 60-month amortization over the amount of depreciation otherwise allowable;

(5) For mining exploration and development costs (other than those relating to an oil or gas well) that were expensed, the excess of the deduction claimed over that allowable if the costs had been capitalized and amortized ratably over a 10-year period;

(6) For circulation expenditures (relating to newspapers, magazines and other periodicals) that were expensed, the excess of the deduction claimed over that allowable if the amounts had been capitalized and amortized ratably over a three-year period;

(7) For research and experimentation expenditures that were expensed, the excess of the deduction claimed over that allowable if the amounts had been capitalized and amortized ratably over a 10-year period;

(8) Percentage depletion to the extent in excess of the adjusted basis of the property;

(9) For net capital gains, the portion (i.e., 60 percent) deducted from gross income under section 1202, except that gain from the sale or exchange of the taxpayer's principal residence was not taken into account;

(10) For incentive stock options, the excess of the fair market value received through the exercise of an option over the exercise price; and

(11) For intangible drilling costs (relating to oil, gas, and geothermal properties) that were expensed, the amount by which the excess portion of the deduction (i.e., the excess of the deduction claimed over that allowable if the costs had been capitalized and amortized ratably over a 10-year period) exceeded the amount of net oil and gas income.

For certain of these preferences, individuals could elect for regular tax purposes to take a deduction ratably over 10 years (three years in the case of circulation expenditures) and thereby to avoid treatment of the item subject to the election as a minimum tax preference. The preferences, in addition to circulation expenditures, with respect to which such an election could be made were research and experimental expenditures, intangible drilling and development costs, and mining exploration and development costs. In addition, the ACRS provisions themselves allowed certain similar elections.[3] In general, a principal reason for making such an election was to preserve for later years the value of an otherwise preferential deduction that would not benefit the taxpayer in the year when the election was made, because the taxpayer was subject to the alternative minimum tax.

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[3] Moreover, in the case of intangible drilling costs, a taxpayer (other than a limited partner or a passive subchapter S shareholder) could elect to forego the expense deduction and claim five-year ACRS and the investment tax credit instead. A taxpayer making this election was not subject to the minimum tax on these items.

Alternative tax itemized deductions

Certain of the itemized deductions allowable in calculating regular taxable income were allowable as well for purposes of calculating alternative minimum taxable income. The alternative tax itemized deductions were:

(1) Casualty or theft losses, and gambling losses to the extent not in excess of gambling gains;

(2) Charitable deductions, to the extent allowable for regular tax purposes;

(3) Medical deductions, to the extent in excess of 10 percent of adjusted gross income;

(4) Qualified interest expenses, which were limited to (a) qualified housing interest (i.e., interest incurred to acquire, construct, or rehabilitate a primary residence or other qualified dwelling used by the taxpayer), plus (b) other interest expenses deducted by the taxpayer, but only to the extent not in excess of qualified net investment income for the year;[4] and

(5) Deductions for estate tax attributable to income in respect of a decedent.

Other regular tax itemized deductions, such as those for state and local taxes paid and for certain investment expenses, were not allowed for minimum tax purposes.

Credits and NOLs

In calculating minimum tax liability, no nonrefundable credits were allowed except for the foreign tax credit. The limitation on the foreign tax credit applying for regular tax purposes (which, in general, prevented use of the credit to offset a greater percentage of one's tax liability than the percentage of taxable income that is foreign source income) applied for minimum tax purposes as well, but was recalculated to reflect the percentage of minimum taxable income coming from foreign sources. Credits that did not benefit the taxpayer due to the imposition of minimum tax liability could be carried back or forward to other taxable years.

Individuals with net operating losses were allowed to deduct such losses against alternative minimum taxable income. However, for years beginning after 1982 the losses were computed, for minimum tax purposes, by reducing the regular tax net operating losses by the amount of the items of tax preference.

Reasons for Change

Congress concluded that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. The ability of high-income taxpayers to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. In addition, even aside from public perceptions, Congress concluded that it is inherently unfair for high-income taxpayers to pay little or no tax due to their ability to utilize tax preferences.

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[4] Since this limitation applied only to itemized deductions for interest expenses, it generally had no effect on interest deductions that were claimed "above-the-line," such as business interest and interest attributable to the production of rents and royalties. Interest to carry limited partnership interests and S corporation stock was treated as an itemized deduction, however.

In particular, Congress concluded that both the perception and the reality of fairness have been harmed by instances in which corporations paid little or no tax in years when they reported substantial earnings, and may even have paid substantial dividends, to shareholders. Even to the extent that these instances may reflect deferral, rather than permanent avoidance, of corporate tax liability, Congress concluded that they demonstrated a need for change.

Congress viewed the minimum taxes under prior law as not adequately addressing the problem, principally for two reasons. First, the corporate minimum tax, as an add-on rather than an alternative tax, was not designed to define a comprehensive income base. Second, the prior law minimum taxes did not sufficiently approach the measurement of economic income. By leaving out many important tax preferences, or defining preferences overly narrowly, the individual and corporate minimum taxes permitted some taxpayers with substantial economic incomes to report little or no minimum taxable income and thus to avoid all liability.

Certain of the tax preferences under prior law applied only to individuals, or only to individuals and personal holding companies. Congress concluded that, in most cases where both individuals and corporations can benefit from a preference for regular tax purposes, the preference should be included in minimum taxable income by both.

With regard to the preference relating to the expensing of research and experimentation expenditures, however, Congress concluded that, for incentive reasons, corporations, including personal holding companies, should not be required to treat such expensing as a preference. At the same time, Congress concluded that such expensing should continue to be treated as a preference for individuals, because of the use of such expensing in tax shelters.

With respect to certain items that constituted tax preferences, at least for some taxpayers, under prior law, Congress concluded that the previous definitions of the preferences were inadequate. In the case of accelerated depreciation on real and personal property, Congress concluded that the useful lives of items of real and personal property generally are longer than the useful lives applying under prior law for minimum tax purposes. Thus, application of such useful lives gave rise to mismeasurement of economic income. At the same time, for incentive reasons, Congress concluded that in most cases taxpayers should not be required to use the straightline method for minimum tax purposes, so long as the method used is not more preferential than that generally applying for regular tax purposes.

With respect to intangible drilling costs, Congress concluded that taxpayers should not be permitted to use the preference to offset all net oil and gas income before being required to include it in the minimum tax base. However, for incentive reasons relating to the financial hardships currently being experienced by the oil and gas industry, Congress concluded that the preference should not be includable in minimum taxable income in full; i.e., the net income offset should be retained in part.

In addition, Congress concluded that certain items, not presently treated as preferences, must be added to the minimum tax base in order for it to serve its intended purpose of requiring taxpayers with substantial economic incomes to pay some tax. The items as to which Congress reached this determination include tax-exempt interest on newly issued private activity bonds (other than those issued on behalf of a section 501(c)(3) organization), use of the completed contract method of accounting, untaxed appreciation deducted with respect to charitable contributions of appreciated property, use of the installment method by certain taxpayers, and the use of tax-favored capital construction funds by shipping companies.

In order to prevent individuals with substantial economic incomes from avoiding liability through the use of tax shelters, Congress concluded that the use of net losses from passive business activities should be limited for minimum tax purposes under rules similar to those applying for regular tax purposes. Both specific minimum tax preferences and limitations on the use of passive losses were considered necessary to ensure that individuals with substantial economic incomes would pay tax whether they used preferences to offset tax on income from a single business activity, or used losses from one activity to offset income from another.

In the case of farming losses of individuals not materially participating in the farming business, Congress concluded that an additional and stricter rule should apply for minimum tax purposes, preventing any loss with respect to a passive farming activity from offsetting other income of the taxpayer prior to disposition. Congress concluded that such a rule was needed, in addition to the general passive loss rules applying for regular and minimum tax purposes, in light of the harm to taxpayers active in the farming business that has resulted from the proliferation of tax shelter farming activities exploiting the competitive cost advantage of passive investors who can use tax losses derived from farming to offset unrelated income.

With respect to corporations, Congress concluded that the goal of applying the minimum tax to all companies with substantial economic incomes cannot be accomplished solely by compiling a list of specific items to be treated as preferences. In order to achieve both real and apparent fairness, Congress concluded that there must be a reasonable certainty that, whenever a company publicly reports significant earnings, that company will pay some tax for the year.

For the years from 1987 through 1989, Congress concluded that this goal should be accomplished by means of a preference based upon financial statement or book income reported by the taxpayer pursuant to public reporting requirements or in disclosures made for nontax reasons to regulators, shareholders, or creditors. Congress concluded that it was particularly appropriate to base minimum tax liability in part upon book income during the first three years after enactment of the Act, in order to ensure that the Act will succeed in restoring public confidence in the fairness of the tax system.

For taxable years beginning after 1989, Congress concluded that the book income preference should be replaced by the use of a broad-based system that is specifically defined by the Internal Revenue Code. Congress intended that this system should generally be at least as broad as book income, as measured for financial reporting purposes, and should rely on income tax principles in order to facilitate its integration into the general minimum tax system.

Congress concluded that the definition of earnings and profits applying for certain regular tax purposes (and amended in several respects by the Act) provided an appropriate starting point in this regard. However, Congress concluded that the definition of earnings and profits required adjustment, for minimum tax purposes, in the interest both of clarification and of conformity to policy objectives of the Internal Revenue Code, including the minimum tax and the book income preference in particular.

Clarification regarding the meaning of earnings and profits, for this statutory purpose, was viewed as necessary due to the lack of legal authorities resolving numerous issues regarding the scope of earnings and profits under present law. In all cases where such clarification is provided, Congress intended that no inference be drawn regarding the scope of earnings and profits under present law or for other statutory purposes.

Moreover, Congress concluded that guidance was needed regarding the treatment of items arising prior to the effective date of the preference, both to assist taxpayers that have not previously computed earnings and profits on an annual basis and in order to conform the preference more closely to the scope of the book income preference, which applies to property placed in service prior to the effective date. Congress viewed it as inappropriate to permit taxpayers to claim deductions for purposes of the preference that are duplicative of deductions claimed for regular or minimum tax purposes in years when the preference did not apply.

In general, Congress concluded that conforming the measurement of earnings and profits to the policy purposes of the Internal Revenue Code requires disallowing deductions that are disallowed for regular tax purposes (e.g., bribes). In addition, in light of the purpose of the preference to include income that otherwise would escape current taxation, Congress concluded that (on a cumulative basis) the income base for the preference should never be narrower than that otherwise applying for minimum tax purposes. In certain circumstances where income is defined more broadly for financial reporting purposes than for any tax purposes, Congress concluded that financial reporting definitions should apply, in order to prevent the avoidance of taxation by companies that report earnings to regulators, shareholders, or creditors.

A further change that Congress viewed as necessary relates to the use of investment tax credits to offset minimum tax liability. In general, under the Act as well as prior law, incentive credits are not permitted to offset such liability, since their allowance would be inconsistent with the goal of taxing economic income. In the case of investment tax credits, however, Congress concluded that some transitional relief was desirable, in order to assist corporations whose investment tax credits might otherwise expire unused due to the newly enacted corporate minimum tax.

In addition, Congress concluded that a change was necessary with regard to the use of net operating losses, foreign tax credits, and investment tax credits to avoid all U.S. tax liability. Absent a special rule, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient such credits and losses available. While Congress viewed allowance of the foreign tax credit and net operating loss deduction, along with the transitional relief relating to the investment tax credit, as generally appropriate for minimum tax purposes, it was considered fair to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income.

Finally, Congress concluded that it was desirable to change the underlying structure of the minimum tax in certain respects. In particular, to the extent that tax preferences reflect deferral, rather than permanent avoidance, of tax liability, some adjustment was considered necessary with respect to years after the taxpayer has been required to treat an item as a minimum tax preference, and potentially to incur minimum tax liability with respect to the item. Absent such an adjustment, taxpayers could lose altogether the benefit of certain deductions that reflect costs of earning income.

Explanation of Provisions

1. Overview

The Act repeals the prior law add-on minimum tax for corporations beginning in 1987, creates a new alternative minimum tax on corporations, and expands the alternative minimum tax on individuals.

Corporations.—Generally, the tax base for the alternative minimum tax on corporations is the taxpayer's taxable income,[5] increased by the taxpayer's tax preferences for the year and adjusted by determining the tax treatment of certain items in a special manner which negates the deferral of income resulting from the regular tax treatment of those events. The resulting amount, called alternative minimum taxable income, then is reduced by an exemption amount and is subject to tax at a 20-percent rate. The amount so determined may then be offset by the minimum tax foreign tax credit, and to a limited extent by investment tax credits. These rules are designed to ensure that, in each taxable year, the taxpayer generally must pay tax equalling at least 20 percent of an amount more nearly approximating its economic income (above the exemption amount). The exemption amount is $40,000, reduced (but not below zero) by 25 percent of the amount by which alternative minimum taxable income exceeds $150,000.

The net minimum tax, or amount of minimum tax due, is the amount by which the tax computed under this system (the tentative minimum tax) exceeds the taxpayer's regular tax.[6] Although the minimum tax is, in effect, a true alternative tax, in the sense that it is computed by applying an alternative rate to an alternative income base and then paying it if and only if it exceeds the regular tax, technically the taxpayer's regular tax continues to be imposed, and the net minimum tax is added on.

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[5] Where a corporation's tax base is measured by something other than taxable income, such as unrelated business taxable income, real estate investment trust taxable income, or life insurance company taxable income, alternative minimum taxable income is determined using that tax base. A technical correction may be appropriate to clarify this result.

Individuals.—The structure for the alternative minimum tax on individuals generally is the same as under prior law, except that adjustments are made to reflect the fact that certain deferral preferences (such as accelerated depreciation) cannot be treated simply as add-ons if total income is to be computed properly over time.[7] For such preferences, the minimum tax deduction may in some instances exceed the regular tax deduction (e.g., in the later years of an asset's life), thus ensuring that basis will be fully recovered under both the regular and the minimum tax systems. The alternative minimum tax on individuals differs from that applying to corporations in several respects. For example, the rate is 21 percent and there are some differences between the preferences applying to individuals and those applying to corporations. In addition, certain itemized deductions that individuals can claim for regular tax purposes are not allowable under the minimum tax. While the exemption amounts for individuals under prior law generally are retained, they are reduced (but not below zero) by 25 percent of the amount by which alternative minimum taxable income exceeds $150,000 ($75,000 for married taxpayers filing separately and trusts, and $112,500 for single taxpayers).

Minimum tax credit.—When a taxpayer pays alternative minimum tax, the amount of such tax paid (i.e., the net minimum tax) is allowed as a credit against the regular tax liability of the taxpayer in subsequent years. However, this credit (known as the minimum tax credit) cannot be used to reduce tax below the tentative minimum tax in subsequent years. The minimum tax credit applies only to minimum tax liability incurred due to deferral preferences (such as accelerated depreciation), i.e., preferences for which the timing, rather than the amount over time, of a deduction or inclusion gives rise to its treatment as a tax preference.

Normative elections.—Taxpayers generally may elect to have the minimum tax treatment of certain expenditures apply for regular tax purposes. When an election is made, no preference is added or treated as an adjustment for minimum tax purposes.

Incentive credits.—Nonrefundable credits (such as the investment tax credit) generally cannot be used to reduce regular tax liability to less than the tentative minimum tax. Credits that cannot be used by the taxpayer due to the effect of the alternative minimum tax can be carried over to other taxable years under the rules generally applying to credit carryovers. In order to provide transition relief, corporations are permitted to use regular investment tax credits to offset up to 25 percent of minimum tax liability.

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[6] A taxpayer's regular tax means the regular tax liability as defined in section 26(b) reduced by the foreign tax credit. It does not include the tax on lump sum distributions under section 402(e) or the recapture taxes under sections 42 and 47. In addition, it is intended that the regular tax be reduced for this purpose by the possessions tax credit under section 27(b) since income eligible for the credit is not in the minimum tax base. A technical correction will be needed to achieve this result.

[7] As a technical matter, alternative minimum taxable income is computed by making adjustments to taxable income, rather than adjusted gross income, as under prior law, in order to conform the structure of the individual minimum tax with the corporate minimum tax.

Separate computation of foreign tax credits and net operating losses for minimum tax purposes.—In general, foreign tax credits and net operating losses are allowed for minimum tax purposes under rules similar in effect to those applying for regular tax purposes. As under the prior law alternative minimum tax on individuals, the amounts of these items are separately computed for regular and alternative minimum tax purposes, respectively. Thus, the amount of such credits or losses accruing to or used by the taxpayer in a particular year may differ under the two systems.

Limitation on use of credits and losses to offset minimum tax liability.—Under the Act, net operating losses, foreign tax credits, and investment tax credits cannot be used to offset, in the aggregate, more than 90 percent of the minimum tax liability that otherwise would be imposed (disregarding the reduction of such liability by the amount of the taxpayer's regular tax liability).

Structure of minimum tax as an alternative system.—For most purposes, the tax base for the new alternative minimum tax is determined as though the alternative minimum tax were a separate and independent income tax system. Thus, for example, where a Code provision refers to a "loss" of the taxpayer from an activity, for purposes of the alternative minimum tax the existence of a loss is determined with regard to the items that are includable and deductible for minimum tax, not regular tax, purposes.[8]

In certain instances, the operation of the alternative minimum tax as a separate and independent tax system is set forth expressly in the Code. With respect to the passive loss provision, for example, section 58 provides expressly that, in applying the limitation for minimum tax purposes, all minimum tax adjustments to income and expense are made and regular tax deductions that are items of tax preference are disregarded.

In other instances, however, where no such express statement is made, Congress did not intend to imply that similar adjustments were not necessary. Thus, for example, for minimum tax purposes it was intended that section 1211 (limiting capital losses) be computed using minimum tax basis, that section 263A (requiring the capitalization of certain depreciation deductions to inventory) apply with regard to minimum tax depreciation deductions, and that section 265 (relating to expenses of earning tax-exempt income) apply with regard only to items excludable from alternative minimum taxable income.[9]

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[8] However, "structural" issues such as whether there has been a taxable event, or whether a particular nonrecognition provision applies, generally are determined identically for regular tax and minimum tax purposes (disregarding, e.g., the situation where a nonrecognition applies only to gains, or only to losses, and a gain or loss, as the case may be, exists only for regular tax, or only for minimum tax, purposes).

[9] Due to the complexity and additional recordkeeping burdens that may result in some cases from such alternative computations, the Treasury may find it appropriate to prescribe regulations that ease compliance. Congress intended that the Treasury have some flexibility in prescribing regulations in this area, to the extent consistent with the intended substantive results.

2. Preferences and adjustments applying to both individuals and corporations

Depreciation

Depreciation on real and personal property to which the new ACRS system applies (generally, property placed in service after 1986) is calculated by using the alternative depreciation system, as described in the depreciation section of this explanation. Generally alternative depreciation is calculated using the applicable ADR midpoint life (forty years in the case of real property).[10] Instead of making an adjustment for each item of property in the amount (if any) by which the regular tax deduction exceeds the normative deduction (as under prior law), the alternative depreciation deduction is substituted for the regular tax ACRS deduction. The principal effect of this system is that it permits "netting", that is, to the extent that an alternative deduction relating to an item of property exceeds the regular tax deduction for that year, a negative adjustment to regular taxable income results.[11]

For minimum tax purposes, as opposed to other purposes for which the alternative depreciation system is relevant, depreciation for certain property is calculated using the 150 percent declining balance method (switching to straightline in the year necessary to maximize the allowance), rather than the straightline method. The 150 percent declining balance method is used with respect to property other than (1) section 1250 property and (2) property with respect to which the taxpayer elects or is required to use a straightline method (over any useful life) for regular tax purposes.

As an exception to the general rule treating ACRS on post-1986 property as a preference, no adjustment is made for minimum tax purposes with respect to property described in paragraph (1), (2), (3), or (4) of section 168(f) (e.g., property depreciated under the units of production method or the income forecast method, etc.).[12]

For all depreciable property to which minimum tax adjustments apply, alternative minimum tax depreciation is controlling for all minimum tax purposes with respect to which the amount of depreciation claimed is relevant. Thus, the adjusted basis of property may differ for regular and minimum tax purposes, giving rise to differing amounts of gain as between the two systems upon the disposition of such property. Similarly, the amount of depreciation that is capitalized to inventory under the uniform capitalization rules (described in Title VIII of this Part) may differ for regular and minimum tax purposes. Further, the restoration of deferred gain or loss for property subject to depreciation under the consolidated return regulations (Treas. Reg. sec. 1.1502-13(d)) may differ for purposes of computing taxable income and alternative minimum taxable income.

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[10] The alternative depreciation system system applies with respect to property leased by a taxable entity to a tax-exempt entity, property placed in service outside of the United States, in measuring depreciation for purposes of determining earnings and profits, and under an election to use the system for regular tax purposes.

[11] Alternative deductions typically exceed ACRS deductions in the later years of the useful life of an item of property for which ACRS is allowed; i.e., at such time the ACRS deduction typically is understated because it has been overstated in prior taxable years.

[12] Property placed in service after 1986 to which the anti-churning rules of section 168(f)(5) apply is subject to the new minimum tax depreciation rules.

Consider, as an example of the depreciation adjustment that does not reflect the actual details of the ACRS and alternative depreciation systems, the case of a taxpayer who was permitted to deduct fully a $10 expense in the year that the property to which the expense related was placed in service, but who was required to amortize the expense over two years for purposes of the alternative depreciation system. For that taxpayer, assuming there were no other differences between the taxpayer's regular and alternative minimum taxable income, regular taxable income would be $5 less than alternative minimum taxable income for the year in which the property was placed in service. In the following taxable year, however, the taxpayer's regular taxable income would be $5 greater than alternative minimum taxable income (because no further regular tax deduction would remain with respect to the property, whereas the taxpayer would still be entitled to deduct the last $5 of basis under the alternative system). If the taxpayer also had a separate preference in the amount of $5 in the second year, the taxpayer's regular and alternative minimum taxable incomes would be equivalent in that year (whether or not that second item related to depreciation).

ACRS depreciation with respect to property placed in service prior to 1987 (unless, pursuant to section 201 of the Act, the taxpayer elects the new ACRS system for regular tax purposes) is treated as a preference only to the extent that it constituted a preference under the rules applying under prior law. Thus, for example, for pre-1987 personal property (other than property with respect to which the new ACRS system is elected for regular tax purposes), ACRS depreciation is a corporate tax preference only in the case of leased personal property in the hands of a personal holding company. In addition, prior law rules generally apply to the measurement of depreciation preferences relating to pre-1987 property. Thus, for example, prior law rules for measuring the amount of accelerated depreciation that constitutes a preference continue to apply to pre-1987 property, and preferences relating to such property continue to be measured on an item-by-item basis, rather than under the netting system described above.[13]

Amortization of certified pollution control facilities

In the case of any certified pollution control facility placed in service after 1986, the taxpayer is required to use the alternative recovery system for minimum tax purposes.

Mining exploration and development costs

Mining exploration and development costs, incurred after 1986, that are expensed (or amortized under section 291) for regular tax purposes are required to be recovered through ten-year straight line amortization for purposes of the alternative minimum tax. As with depreciation, the minimum tax treatment of mining exploration and development costs involves a separate calculation for all items of income and expense relating to such costs. Thus, for example, in the case of a taxpayer who incurred a one-time mining exploration and development expense in the amount of $100, the regular tax deduction would be $100 in the year when the expenditure was incurred, and the minimum tax deduction would be $10 for each of the ten years beginning in the year when the expenditure was incurred. The basis of property with respect to which such costs were incurred, and the amount of gain or loss upon disposition, likewise may differ for regular and minimum tax purposes, respectively.

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[13] As a transition rule, property grandfathered under the depreciation rules (by reason of section 203 or 204 of the Act) is treated for purposes of the depreciation preference as property placed in service prior to 1987. For property that is depreciated under the new ACRS rules during a taxable year of the taxpayer that begins before 1987, it is intended that the new minimum tax depreciation rules apply to measure amount of the preference for such taxable year, but the preference only applies to property to which the prior law rules of section 57(a)(12) applied and the old minimum structure (e.g., no minimum tax credit) continues to apply for such taxable year. A technical correction may be necessary to achieve this result.

Under this approach, any mining exploration and development costs that are included in regular taxable income when the mine reaches the producing stage are not included in minimum taxable income. In addition, when a loss is sustained with respect to a mining property (e.g., the mine is abandoned as worthless, giving rise to a loss under section 165), the taxpayer is permitted to deduct, for minimum tax purposes, all mining exploration and development costs relating to that property that have been capitalized and not yet written off under the minimum tax.

Use of completed contract and other methods of accounting for long-term contracts

In the case of any long-term contract entered into by the taxpayer on or after March 1, 1986, use of the completed contract method of accounting (or any other method of accounting that permits deferral of income during the contract period) is not permitted for purposes of the minimum tax. Instead, the taxpayer is required to apply the percentage of completion method (determined using the same percentage of completion as used for purposes of the regular tax) in determining minimum taxable income relating to that contract. As with depreciation and mining exploration and development costs, this preference is calculated, not by adding an amount to regular taxable income, but by substituting the minimum tax treatment for the regular tax treatment with respect to all items arising with respect to a contract to which the preference relates.

Installment method of accounting

In the case of dispositions of property described in section 1221(1) (relating to dealer property) after March 1, 1986, use of the installment method of accounting is not permitted for purposes of the minimum tax. In addition, other dispositions of property after August 16, 1986, which are subject to proportionate disallowance under the new installment sale rules (i.e., sales of trade or business or rental real property where the purchase price exceeds $150,000 and certain related party corporate sales) may not be reported on the installment method for purposes of the minimum tax. Instead, all payments to be received under the contract must be reported in the year of sale. This rule does not apply to sales of timeshares and residential lots to which the special rules of new section 453C(e)(4) apply.

In the case of a disposition of dealer property occurring after March 1, 1986, and before January 1, 1987 (in the case of a calendar-year taxpayer), with respect to which the taxpayer reports gain under the installment method for regular tax purposes, the result of the applicable effective date for installment sales is that all gain is treated as recognized for minimum tax purposes in 1986. Since the alternative minimum tax as amended by the Act is not effective until taxable years beginning in 1987, the rule's sole effect on the tax treatment of such a disposition is that amounts relating to the disposition, included in regular taxable income in years beginning after 1986 under the installment method, are not included in alternative minimum taxable income for such years.

Percentage depletion

As under prior law, the excess of the regular tax deduction allowable for depletion over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year) is treated as a preference. Thus, for example, a taxpayer who claimed a deduction for percentage depletion in the amount of $50, with respect to property having a basis (disregarding this deduction) of $10, would have a minimum tax preference in the amount of $40.

Intangible drilling costs

The preference for intangible drilling costs is generally the same as the prior law preference for individuals, except that it is expanded to apply to all corporations, and only 65 percent, rather than 100 percent, of net oil and gas income may offset the preference. Thus, the amount of excess intangible drilling costs is treated as a preference to the extent that it exceeds 65 percent of the taxpayer's net income from oil, gas, and geothermal properties. Net oil and gas income is determined without regard to deductions for excess intangible drilling costs. Under this rule, for example, a taxpayer with $100 of net oil and gas income (disregarding excess intangible drilling costs) and $80 of excess intangible drilling costs would be required to treat such costs as a preference in the amount of $15 ($80 excess IDC less $65 net income offset).

The amount of excess intangible drilling costs is defined as the amount of the excess, if any, of the taxpayer's regular tax deduction for such costs (deductible under either section 263(c) or 291(b)) over the normative deduction, i.e., the amount that would have been allowable if the taxpayer had amortized the costs over 120 months on a straight-line basis or (if the taxpayer so elects) through cost depletion. The preference does not apply to costs incurred with respect to a nonproductive well.

As under prior law, excess intangible drilling costs are computed by reducing the deductible IDC's paid or incurred during the taxable year by the amount of the IDC's paid or incurred in that taxable year which could have been deducted in that year had those costs been capitalized and amortized. Thus, for example, assume an integrated oil company incurs $1 million of IDC's in 1987, and deducts $760,000 of those costs in 1987 (in accordance with sections 263(c) and 291(b)), and deducts the remaining costs, $60,000 per year in years 1988 through 1991 (in accordance withe section

291(b)). Also assume that had these costs been capitalized, a deduction of $50,000 would be allowed in 1987, $100,000 in years 1988 through 1996, and $50,000 in 1997. In this example, the excess intangible drilling costs in 1987 would be $710,000 ($760,000 less $50,000). The remaining costs incurred in 1987 would be disregarded in computing the preference in subsequent years. The amount of excess intangible drilling costs for 1988, for example, would be computed by taking into account only those costs incurred in 1988. As described later, the corporation could elect to capitalize all or a portion of its IDC's and amortize them over a 10-year period for purposes of both the regular tax and minimum tax.

In applying the preference for intangible drilling costs, a taxpayer's property (as under prior law for individuals) is divided into two parts: properties that are geothermal deposits, and all other properties with respect to which intangible drilling costs are incurred. This separation applies for all purposes under the minimum tax. Consider, for example, the case of a taxpayer who has (1) oil wells with net oil and gas income of $100 and excess intangible drilling costs of $80, and (2) geothermal deposits with net income of $100 and excess intangible drilling costs of $40. This taxpayer has a preference in the amount of $15 with respect to the oil wells, and no preference with respect to the geothermal deposits.

Tax-exempt interest on private activity bonds

Interest on certain tax-exempt bonds issued after the applicable date is treated as a preference. This rule applies only with respect to private activity bonds (other than qualified 501(c)(3) bonds), the interest on which is exempt from taxation under section 103. Moreover, the preference applies only to such bonds issued on or after August 8, 1986 (on or after September 1, 1986, in the case of bonds that would not have been industrial development bonds (IDB's) under prior law (but using the revised security interest test provided under the Act, other than the 10 percent limit).

For purposes of this rule, interest on bonds issued exclusively to refund (including a series of refundings) an issue of bonds issued before August 8,1986 (or September 1, 1986, if applicable) is not a preference item.

In the case of a taxpayer who is required to include in alternative minimum taxable income any interest that is tax-exempt for regular tax purposes, section 265 (denying deductions for expenses and interest relating to tax-exempt income) does not apply, to the extent of such inclusion, for purposes of the minimum tax. Thus, for example, a taxpayer who incurs interest expense with respect to purchasing or carrying a private activity bond issued in 1987, and who is denied a deduction with respect to such expense for regular tax purposes under section 265, is allowed the deduction for minimum tax purposes where the interest is included in alternative minimum taxable income.

For regular tax purposes, however, the application of section 265 to deny certain interest deductions is unaffected by the fact that the related interest income may be includable for minimum tax purposes.

Charitable contributions of appreciated property

In the case of a taxpayer who makes one or more charitable contributions of appreciated capital gain property, an amount equal to the regular tax deduction claimed with respect to such appreciation is treated as a minimum tax preference. Thus, the charitable contribution deduction is generally limited to the taxpayer's adjusted basis in the property. For purposes of this rule, capital gain property has the same meaning as under the rules relating to charitable deductions.

In the case of a contribution of less than the taxpayer's entire interest in appreciated property, the preference shall be computed by applying the principles applicable under section 170(e), relating to contributions of ordinary income property. (See Treas. Reg. 1.170A-4(c)).

The amount of the preference is determined by disregarding any amount that is carried forward to another taxable year for purposes of the regular tax. Thus, when a portion of a charitable deduction is carried forward because it exceeds the applicable percentage limitation on such contributions, the portion so carried forward cannot increase the amount of the minimum tax preference until it is allowed as a deduction for regular tax purposes.

Where a taxpayer makes charitable contributions in excess of those for which a regular tax charitable deduction is allowed during the taxable year, the minimum tax consequences require determining which contributions (or portions thereof) are deducted, and which are carried forward. The minimum tax charitable deduction (net of the preference) is computed by in effect using basis in place of fair market value. Thus, no preference should apply unless the relevant basis of property contributed is less than the amount of the regular tax deduction.

For example, assume that in year 1 a taxpayer with an adjusted gross income of $100,000 is allowed a charitable deduction of $30,000. The taxpayer has made a charitable contribution of property having an adjusted basis of $50,000 and fair market value of $150,000. In year 1, the taxpayer's minimum tax deduction (net of the preference) equals $30,000 since the basis of the contributed property exceeds the amount deductible for regular tax purposes. In year 2, if the taxpayer again is allowed to deduct $30,000 for regular tax purposes and has made no additional charitable contributions, the deduction for minimum tax purposes is limited to $20,000.

The preference does not apply with respect to charitable contributions made before August 16, 1986. In the case of a contribution made on or after August 16, 1986, and before the beginning of the first taxable year beginning after December 31, 1986, the preference applies only with respect to amounts carried forward to taxable years beginning after December 31, 1986. Thus, for example, in the case of a calendar year taxpayer, the preference applies, with respect to a contribution made on or after August 16, 1986, and before January 1, 1987, to amounts carried forward to the 1987 taxable year or thereafter. In the case of gifts made in 1986, the gifts shall be treated as deductible in the order made in determining the character of carryovers to 1987 and later years. Thus, for example, if a calendar year taxpayer made a charitable contribution of property having an adjusted basis of $50,000 and a fair market value of $100,000 in April, 1986, and made a similar contribution in October, 1986, and was allowed to deduct only $175,000 in light of his adjusted gross income, the $25,000 carryover to 1987 is treated as being attributable to appreciation on the October contribution and therefore is a tax preference in 1987 assuming that the $25,000 is deductible in that year.

3. Additional preferences and adjustments (other than limitations on itemized deductions) applying to individuals

Circulation expenditures

An individual who incurs circulation expenditures described in section 173 is not permitted to expense his post-1986 expenditures for minimum tax purposes. Instead, in computing alternative minimum taxable income, the taxpayer is required to amortize such post-1986 expenditures ratably over a three-year period. However, if the taxpayer realizes a loss with respect to property to which any such expenditures relate, all such expenditures relating to that property but not yet deducted for minimum tax purposes are allowed as a minimum tax deduction. The preference applies to personal holding companies as well as to individuals.

For example, an individual who incurred such expenditures in the amount of $30 would claim a regular tax deduction for the entire amount in the year when the expenditures were incurred, and would claim alternative minimum tax deductions of $10 for that year and the two succeeding taxable years. However, if the newspaper to which the expenditures related ceased operations in the second year, the entire $20 which was not allowed as a minimum tax deduction in the first year would be allowed for minimum tax purposes in the second year.

Research and experimental expenditures

An individual who incurs research and experimental expenditures described in section 174 is not permitted to expense the expenditures for minimum tax purposes. Instead, in computing alternative minimum taxable income, the taxpayer is required to amortize such post-1986 expenditures over a ten-year period. As with certain other items (such as depreciation and mining exploration and development costs), this treatment applies for all minimum tax purposes, rather than as an annual adjustment to regular taxable income. If the taxpayer abandons a specific project to which any such expenditures relate, all such expenditures relating to that property but not yet deducted for minimum tax purposes are allowed as a minimum tax deduction.

For example, an individual who incurred research and experimental expenditures in the amount of $100 would claim a regular tax deduction for the entire amount in the year when the expenditures were incurred (absent a section 174(b) election), and would claim alternative minimum tax deductions of $10 for that year and the nine succeeding taxable years. However, if the taxpayer abandoned the specific project to which the expenditures related in the second year, the entire $90 which was not allowed as a minimum tax deduction in the first year would be allowed for minimum tax purposes in the second year.

Incentive stock options

As under prior law, in the case of a transfer of a share of stock pursuant to the exercise of an incentive stock option (as defined in section 422A), the amount by which the fair market value of the share at the time of the exercise exceeds the option price is treated as a preference. For purposes of this rule, the fair market value of a share is determined without regard to any restrictions other than one which, by its terms, will never lapse.

For minimum tax purposes, the basis of stock acquired through the exercise of an incentive stock option after 1986 includes the amount of the preference.[14] Assume, for example, that an individual pays an exercise price of $10 to purchase stock having a fair market value of $15. The preference in the year exercise is equal to $5, and the stock has a basis of $10 for regular tax purposes and $15 for minimum tax purposes. If, in a subsequent year, the taxpayer sells the stock of $20, the gain recognized is $10 for regular tax purposes and $5 for minimum tax purposes.

Passive farm losses

Any passive farm loss of an individual or personal service corporation (within the meaning of section 469(j)(2)), to the extent not already denied for minimum tax purposes under the rules described above, is not allowed in computing alternative minimum taxable income. A passive farm loss is defined as the excess of the taxpayer's loss for the taxable year from any tax shelter farming activity. The amount of the loss which is otherwise disallowed is reduced, however, by the amount, if any, of the taxpayer's insolvency, as measured using a standard similar to that set forth in section 108(d)(3).

For purposes of this provision, the term "tax shelter farm activity" means (1) a farming syndicate (as defined in section 464(c)), and (2) any other activity consisting of farming which is a passive activity (within the meaning of section of section 469(c)).

Under the passive farm loss rule, deductions allocable to a tax shelter farming activity, to the extent in excess of gross income allocable to the activity, are disallowed for minimum tax purposes. A separate activity is defined consistently with section 469, with the result that generally each farm is treated as a separate activity.

The rules for applying the loss disallowance generally are similar to those for applying the passive loss rule for minimum tax purposes (see below), except that there is no netting between different farming activities. An excess farming loss with respect to any farming activity is disallowed even if there is net income from other farming activities. Thus, for example, an individual who has a net gain of $50 from one passive farming activity and a net loss of $50 from a second passive farming activity has a preference in the amount of $50.

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[14] Because the Act allows a basis adjustment for the amount of the preference, it is intended that the preference apply where there is an early disposition of the stock causing income to be increased in the year of disposition by reason of section 421(b). A technical correction may be appropriate to clarify this result.

The passive farm loss rule is applied, in computing alternative minimum taxable income, prior to the passive loss rule. Thus, the only passive farming activities that enter into the passive loss computation (for minimum tax purposes) are those that generate net gain. Such gain can then be offset, for minimum tax purposes under the general passive loss rule, against passive losses that are not from farming activities.

The amount of the deductions allocable to a farming activity is determined after taking account of all preferences and making all adjustments required for the determination of alternative minimum taxable income, other than the preference for excess passive activity losses. In other words, no deduction which is treated as a minimum tax preference, or which is redetermined (as with depreciation) for minimum tax purposes, is "double-counted" by also being considered in the determination of excess farm losses.

To the extent that a loss from a farming activity is disallowed under this rule, the amount is treated, for minimum tax purposes, as a farm loss incurred in the same activity in the succeeding taxable year. Thus, it is allowed as a minimum tax deduction in the succeeding year, to the extent that the taxpayer otherwise has net income from the farm in such year, or upon an appropriate disposition (i.e., a disposition that would qualify under the passive loss rules as triggering the allowance of suspended losses from the activity). Congress generally intended that other aspects of the disposition rules applying with respect to passive losses apply as well for minimum tax purposes with respect to passive farming losses.

Passive activity losses

In computing alternative minimum taxable income, limitations apply to the use of losses from passive activities of the taxpayer to offset other income of the taxpayer. The rule is identical to that applying for regular tax purposes, under section 469 of the Code, except for three differences. First, the rule is fully effective in 1987 for minimum tax purposes, whereas it is phased in for regular tax purposes. Second, solely for minimum tax purposes, the amount of losses that otherwise would be disallowed for the current taxable year under the limitation is reduced by the amount, if any, of the taxpayer's insolvency, as measured using a standard similar to that set forth in section 108(d)(3). Third, in applying the limitations, minimum tax rules (including the passive farm loss rule) apply to the measurement and allowability of all relevant items of income, deduction, and credit. In light of differences between the regular tax and minimum tax treatment of such items, the amount of suspended losses relating to an activity may differ for regular and minimum tax purposes, respectively.

As under the regular tax, the passive loss limitation applies not only to individuals, but also to personal service corporations and closely held corporations (as defined for purposes of section 469). For closely held corporations that are not personal service corporations, the same more limited version of the passive loss rule that applies for regular tax purposes applies for minimum tax purposes;

i.e., passive losses can offset net active income but cannot offset portfolio income.

The passive rule applying for minimum tax purposes functions, in effect, like an adjustment to the regular tax rule. Thus, when a taxpayer has deductions that are limited under the regular tax passive loss rule, such regular tax limitations should be disregarded for minimum tax purposes, with the minimum tax limitation being applied instead. Taxable income is first reduced, by treating as allowable deductions that were suspended under the regular tax passive loss rule, then adjusted, to reflect minimum tax adjustments and other preferences, and then potentially increased by applying the minimum tax passive loss rule.

For example, assume that in 1991 (when the passive loss rules are fully phased in for regular tax purposes) a taxpayer has $200,000 of salary income and $50,000 of gross income from passive activities. The taxpayer's deductions with respect to the passive activities equal $120,000 for regular tax purposes and $80,000 for minimum tax purposes. For regular tax purposes, the taxpayer has income of $200,000 and a suspended passive loss in the amount of $70,000. For minimum tax purposes, the taxpayer has income of $200,000 and a suspended passive loss of $30,000.[15]

4. Business untaxed reported profits and adjusted current earnings

In general

The Act provides that alternative minimum taxable income of a corporation is increased by a percentage of the amount by which an alternative measurement of income exceeds the amount otherwise determined to be the alternative minimum taxable income for the year. For taxable years beginning in 1987, 1988 and 1989, alternative minimum taxable income is increased by one-half of the amount by which the adjusted net book income of the taxpayer exceeds the alternative minimum taxable income of the taxpayer before any amount is added to alternative minimum taxable income as a result of this preference and before adjustment for any net operating loss carryovers (unadjusted alternative minimum taxable income). For taxable years beginning after 1989, alternative minimum taxable income is increased by seventy-five percent of the amount by which the adjusted current earnings of the corporation exceeds its unadjusted alternative minimum taxable income.

These preferences are determined as a percentage of the excess of adjusted net book income (for taxable years beginning in 1987, 1988, and 1989) or of adjusted current earnings (for later taxable years) over unadjusted alternative minimum taxable income. For this purpose, a positive amount is always considered to be in excess of a negative amount and a smaller negative amount in excess of a larger negative amount.

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[15] Under this rule, it is possible for a taxpayer to have a passive loss under one system but not under the other. For example, assume that the above taxpayer's deductions with respect to passive activities equalled $80,000 for regular tax purposes and $40,000 for minimum tax purposes. The taxpayer would have regular taxable income of $200,000, a suspended passive loss of $30,000 for regular tax purposes, alternative minimum taxable income of $210,000, and no suspended passive loss for minimum tax purposes.

For example, corporation A has adjusted net book income in 1988 of $100 and unadjusted alternative minimum taxable income (prior to the inclusion of any amount as a result of this preference) of $50. Adjusted net book income exceeds the unadjusted alternative minimum taxable income by $50, one-half of which ($25) is added to unadjusted alternative minimum taxable income to give an alternative minimum taxable income for the year of $75.

Corporation B has adjusted net book income of $100 and unadjusted alternative minimum taxable income of negative $50 in 1988. In this case, adjusted net book income exceeds unadjusted alternative minimum taxable income by $150, one-half of which ($75) must be added to unadjusted alternative taxable income, resulting in alternative minimum taxable income for the year of $25.

Corporation C has adjusted net book income of negative $100 (a loss of $100) and unadjusted alternative minimum taxable income of negative $200 in 1988. The adjusted net book income exceeds alternative minimum taxable income by $100, one-half of which ($50) is added to unadjusted alternative taxable income, resulting in alternative minimum taxable income for the year of negative $150.

Business untaxed reported profits ("book income")

In general

During the taxable years for which the business untaxed reported profits ("book income") provision is effective, the amount of preference is determined by comparing the adjusted net book income of the taxpayer with its unadjusted alternative minimum taxable income. In general, the book income used in computing the adjusted net book income of a corporate taxpayer is the net income or loss set forth on the taxpayer's applicable financial statement. Certain adjustments are made to conform net income to reflect the activities of the corporation or corporations included in the tax return, to remove the effect of Federal and foreign income taxes, and for other purposes. The Secretary of the Treasury is not empowered to adjust book income except in cases where there is the omission or duplication of an item of income or expense, where the principles of the book income provision otherwise would be avoided through the disclosure of financial information through footnotes or other supplementary statements, or where adjustment is proper under the principles of section 482.

Financial statement income

The starting point for the computation of the book income preference is the net income disclosed on the taxpayer's applicable financial statement. Net income is the amount the taxpayer reports that takes into account all items of revenue, expense, gain and loss attributable to the taxable year according to the taxpayer's method of accounting. Thus, net income can include income that would otherwise be tax-exempt, such as tax-exempt interest or gain from a tax-free reorganization.

Normally, net income will be disclosed as part of an income statement prepared for inclusion in the taxpayer's applicable financial statement. The amount of net income should reconcile with the balance sheet of the corporation and be the same amount used in any computation of changes in owners' equity. Alternative measures of net income, such as a statement of sources and uses of funds or inflation-adjusted income statements, are not to be considered as determining net income unless the taxpayer determines its asset, liability, and owners' equity balances on its applicable financial statement in accordance with such an approach.[16]

The taxpayer's applicable financial statement generally is expected to include an income statement, a balance sheet stating the amount of assets, liabilities, and owners' equity, a statement of changes in owners' equity, and such other information as is determined to be appropriate for disclosure. An income statement by itself may constitute a taxpayer's applicable financial statement where the other materials generally expected to be included are not prepared or used by the taxpayer. However, an income statement that does not reconcile with financial statement materials otherwise issued generally will not be considered as establishing net income for the purpose of computing this preference.

The taxpayer's applicable financial statement is the statement it provides for regulatory or credit purposes, for the purpose of reporting to shareholders or other owners, or for other substantial nontax purposes. In the case of a corporation that has more than one financial statement, rules of priority are provided for the determination of which statement is to be considered as the applicable financial statement for the purpose of determining net book income.

The highest priority is given to financial statements that are required to be filed with the Securities and Exchange Commission. Second in priority are audited financial statements that are certified by a professional accountant and used for credit purposes, for reporting to shareholders or other owners, or for any other substantial nontax purpose. For this purpose, a financial statement is considered to be certified if it is accompanied by an opinion of a professional accountant stating that the financial statement generally is consistent with the taxpayer's accounting principles. Third in priority are financial statements required to be provided to the Federal Government or its agencies (other than the Securities and Exchange Commission), a State government or its agencies, or a political subdivision or its agencies.

In the absence of any of the above, any financial statement or report that is used for credit purposes, for reporting to shareholders or other owners, or for any other substantial nontax purpose is considered the applicable financial statement. Within a category of priority (other than in the case of financial statements filed with the Securities and Exchange Commission or required to be provided to a government or its agencies), a financial statement used for credit purposes has the highest priority, followed by a financial statement provided to shareholders or other owners. A financial statement used for any other substantial nontax purpose has the lowest priority.

In applying these rules of priority, the financial statement actually must be used for reporting for credit purposes, to shareholders, or for a substantial nontax purpose. A financial statement that is not so used is not eligible to be considered as the applicable financial statement in the calculation of the book income preference amount. For example, an unregulated corporation may obtain a certified, audited financial statement, but report to creditors and shareholders using an alternative financial statement that is neither audited nor certified. In such an instance, the alternative, unaudited financial statement is the applicable financial statement and the net income stated in it is used in determining the amount of the preference.

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[16] Financial statement income generally will include the amount of any interest received by the taxpayer that otherwise is exempt from taxation (e.g., interest described in section 103).

An income tax return, franchise tax return or other similar return prepared for the purpose of determining any tax liability that is filed with Federal, State or local authorities is not intended to constitute a financial statement for the purpose of determining what is the applicable financial statement of the taxpayer.[17] For example, a taxpayer files income tax returns with Federal and state authorities, and also prepares a financial statement for credit purposes that is not certified by a professional accountant. The tax returns will not be considered to be financial statements and the uncertified financial statement prepared for credit purposes will be treated as the applicable financial statement for this taxpayer.

Congress anticipated that corporate taxpayers will generally have one or more of the above financial statements. Taxpayers generally are required to maintain books and records. If the books and records of the taxpayer are themselves used for credit, stockholder reporting or other substantial non-tax purposes, they may be summarized to yield a financial statement, that summarization may be used as the applicable financial statement for the purpose of determining the preference amount. In the case where the taxpayer has no applicable financial statement within the meaning of this provision, the net income or loss of the taxpayer for financial reporting purposes will be considered to be equal to the taxpayer's current earnings and profits for the taxable year.

For this purpose, current earnings and profits shall be determined without diminution by reason of distributions or payments of federal or foreign income taxes during the taxable year. Moreover, for purposes of this provision, earnings and profits shall not be determined with regard to the adjusted current earnings calculation applicable for years beginning after 1989. In calculating earnings and profits for an affiliated group of corporations filing a consolidated return, appropriate adjustments will be made, as prescribed by the Secretary of the Treasury, to prevent the double inclusion of earnings and profits through the operation of the consolidated return regulations or otherwise.

A taxpayer that does not file a financial statement with the Securities and Exchange Commission, a government or governmental agency or obtain a certified, audited financial statement may elect to use the earnings and profits for the taxable year in place of the net income disclosed on its applicable financial statement. A taxpayer making such an election is required to continue to use the earnings and profits calculation so long as it is eligible for the election.

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[17] A technical correction may be appropriate to clarify this result.

In certain cases, adjustments may be made to reported financial statement income after the financial statements have been issued. In the case where a higher priority financial statement has been issued that is not adjusted, but a lower priority financial statement is adjusted, the higher priority, unadjusted financial statement will continue to be considered the applicable financial statement.

For example, a corporation obtains a certified, audited financial statement that it provides to its shareholders. Later, it is determined that the results of the corporation would be better reflected by the use of an alternative accounting method as to certain items. A second income statement reflecting the alternative accounting method is prepared for credit purposes, but it is not certified by a professional accountant and the earlier certified statement is not recalled for correction. As the earlier certified statement has a higher priority than the later uncertified statement, the earlier statement will be considered the applicable financial statement and used in determining the preference amount. If the earlier statement had not been certified, the later statement would be the applicable financial statement, since the provision of a statement for credit purposes has priority over a statement issued to shareholders where both or neither are certified.

A similar problem may arise where financial statements are not restated, but supplementary documents are provided to allow the user of the information to determine a different measure of income. If such is the case, the issuance of the supplementary documents will be considered to be the same as the issuance of a restated income statement.

Adjustments

In order to determine properly the amount by which net book income exceeds alternative minimum taxable income, certain adjustments are required to be made.

The book income preference item is determined with regard to the companies included in the taxpayer's income tax return for the year.[18] To the extent that different companies may be included for financial statement purposes, it is necessary to adjust net book income so that it reflects the same companies that are included in the tax return. It is anticipated that this adjustment will be accomplished by removing the net income and any related consolidating eliminations of companies that are included for financial statement purposes but not for Federal income tax purposes, and by adding in the net income and related consolidating eliminations of companies that are excluded for financial statement purposes but included for Federal income tax purposes. In determining the consolidating eliminations of companies included for Federal income tax purposes but not for financial statement purposes, the method of consolidation that the taxpayer normally uses for financial statement purposes will be followed (other than eliminations of minority interest, discussed below).

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[18] Thus, for example, a consolidated return does not include foreign companies or section 936 corporations, which cannot be consolidated for tax purposes. Corporations that are not included in the taxpayer's consolidated group income tax return may themselves be subject to this preference. In the case of a corporation that is eligible for the section 936 credit, however, book income is adjusted to remove any amount that meets the requirements of section 936(a)(1)(A) or (B), as discussed below.

In order to include the full amount of net book income attributable to companies included in the taxpayer's consolidated income tax return for the year, an adjustment is necessary to eliminate any adjustments to book income for minority interests in such companies. This is the case whether the reduction for the minority interest is disclosed seperately in the applicable financial statement (by line item, footnote, or otherwise) or is included with other deductions or eliminations. Where the reduction for the minority interest is stated net of Federal or foreign income tax, the amount of this adjustment is the full amount of net income reduced for the minority interest, without reduction for the minority interest's share of such taxes.

A taxpayer is required to record as an item of net book income the gross amount (i.e., gross of any withholding taxes) of any actual distribution (e.g., an actual dividend and any associated section 78 gross-up dividend) or the amount of any deemed distribution (e.g., a subpart F inclusion from a controlled foreign corporation) from another corporation if the other corporation is not included in the taxpayer's income tax return for the year. If the taxpayer includes its ownership of the other corporation for financial purposes using another method, such as by consolidation or by the equity method, an adjustment to reverse the inclusion of the other corporation is required.

The gross amount of dividends received from a section 936 corporation, like dividends received from other nonconsolidated corporations, are included in the recipient's adjusted net book income. To the extent that the alternative minimum taxable income of the recipient is increased by reason of the inclusion of such dividends in adjusted net book income, a pro rata portion of withholding or income[19] taxes is treated, for minimum tax purposes, as creditable foreign taxes paid by the recipient. The maximum amount of withholding or income taxes that may be treated as creditable foreign taxes is 50 percent of the taxes. However, this amount is reduced on a proportionate basis if a lesser amount of the dividends from the 936 corporation is taken into account in computing adjusted net book income.

Assume, for example, that a corporation receives a dividend in the amount of $90 from a section 936 corporation from which $10 of Puerto Rican tax has been withheld. The recipient's adjusted pre-tax book income includes this $100. If adjusted net book income, disregarding this inclusion, equals or exceeds the unadjusted alternative minimum taxable income of the recipient, then the result of the inclusion is to increase alternative minimum taxable income by $50 (50 percent of $100). Accordingly, the amount of foreign taxes potentially creditable for minimum tax purposes by the recipient includes $5 (50 percent of $10) of the Puerto Rican withholding tax.

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[19] A technical correction may be necessary to achieve this result.

Assume that, in the above example, the recipient's adjusted net book income, disregarding the receipt of the above dividend, is $20 less than unadjusted alternative minimum taxable income. Accordingly, after inclusion of the dividend, adjusted net book income exceeds unadjusted alternative minimum taxable income by $80, and the book preference results in a $40 increase in the amount of alternative minimum taxable income. Since this increase is 40 percent of the full amount of the dividend, the amount of foreign taxes potentially creditable for minimum tax purposes includes only $4 (40 percent of $10) of the withholding tax.

Where a corporation is included in the taxpayer's consolidated tax return for the year, but is included in the applicable financial statement measure of net income only when dividends are paid, adjusted net book income includes the net income and related consolidated eliminations of the payee corporation. In this case, the taxpayer's net book income is adjusted to eliminate any dividends from the payee corporation.

The book income preference is a measurement of the amount by which pretax financial statement income of the taxpayer exceeds its unadjusted alternative minimum taxable income. Thus, it is necessary to remove items of financial statement income and expense that relate to federal or foreign income taxes. This includes both items of tax provision that are separately stated and any items of tax expense or benefit that may be included in other items of income or expense. Such other items must be restated separately from their tax components for the purpose of computing adjusted net book income. Any provision for state and local taxes is considered allowable for the purpose of computing adjusted net book income and no adjustment is made to remove these items in determining book income.

If the taxpayer elects to deduct foreign income taxes, rather than claim a credit for these taxes, the taxes are treated in the same manner as state and local taxes. Since taxes paid to Puerto Rico that are attributable to income of a 936 corporation which qualifies for the benefits thereof are neither allowed as a credit or deduction for regular tax purposes, these taxes generally are not deductible for this purpose. Thus the amount of dividends from 936 corporations that is included in adjusted net book income is the gross amount of the dividends. Moreover, foreign taxes which are required to be deducted (and cannot be claimed as a credit) are to be treated in the same manner as state and local taxes.

Any item of Federal or foreign income tax expense or benefit (other than foreign taxes deducted in lieu of being claimed as a credit) attributable to any adjustment of deferred taxes resulting from the corporate tax rate changes of this Act or any subsequent legislation is not included in the computation of adjusted net book income for minimum tax purposes.

In the case of a corporation that uses a different accounting year for financial statement purposes than the taxable year it uses for federal income tax purposes, it is anticipated that an adjustment to net book income will be required in order to conform the financial accounting and taxable years for the purpose of computing adjusted net book income. Generally, the corporation will be required to include a pro rata portion of each financial statement accounting year that includes the federal income tax taxable year. The use of a 52-53 week year will be considered to be the use of the annual year that ends during the same week as the 52-53 week year ends.

It is anticipated that, if an applicable financial statement for an accounting year that is to be included on a pro rata basis is not available by the time for filing of a taxpayer's federal income tax return (including any extensions), a reasonable estimate of the amount of adjusted net book income to be included will be made, and that the taxpayer's Federal income tax return will be amended to reflect the pro rata amount when the applicable financial statement is available. It is also anticipated that, if an accounting year that must be included on a pro rata basis has not ended by the time for filing of a taxpayer's Federal income tax return (including extensions), the Secretary of the Treasury will prescribe circumstances in which an election will be made available to use adjusted net book income for the accounting year that ends within the taxpayer's taxable year in lieu of making this adjustment. Such an election, once made, would be irrevocable other than with the consent of the Secretary.

Extraordinary items are included in adjusted net book income unless they are items of tax benefit or expense, such as the use of a foreign tax or net operating loss carryforward. Extraordinary items that are stated net of tax must be adjusted to remove any Federal or foreign income tax expense or benefit components before the extraordinary item is included in adjusted net book income.

The Act provides the Secretary of the Treasury with the authority to issue regulations requiring the adjustment of net book income to prevent the omission or duplication of any item. It is anticipated that this grant of authority will be used, for example, to prevent the recording of items directly to the financial statement asset, liability, or equity accounts that are properly included as items of financial statement income or expense. It is also anticipated that this grant of authority will be used to prevent the use of asset, liability or equity accounts to offset items of income or expense that would otherwise not be allowed. In exercising this authority, it is anticipated that the principles of section 482 will also be applied.

For example, an otherwise entirely domestic consolidated group for financial accounting purposes contains a single foreign corporation that is not subject to U.S. Federal income tax. The consolidated group enters into financing arrangements with the foreign corporation that result in the transfer of all the net income of the group to the foreign corporation. Although the usual rules would provide that all of the income attributable to the foreign corporation would not be included in determining the adjusted net book income of the consolidated group for tax purposes, it is expected that the regulations under this provision would reassign such income to the domestic corporations, making it subject to inclusion in the calculation required by this provision.

Another situation in which the exercise of regulatory authority was anticipated may arise where taxpayers restate prior year financial statements rather than making adjustments to the financial statement for the current period (a prior period adjustment). To prevent the manipulation of book income for the purposes of this provision, it is intended that book income for the current year be adjusted by the cumulative effect of the prior period adjustment on retained earnings or other equity account. However, this adjustment to book income shall be made only to the extent that the prior period adjustment pertains to a period occurring on or after the effective date of this provision.

Other taxpayers might seek to claim depreciation deductions in excess of the basis of the asset, offsetting such additional financial statement depreciation expense with a contra-asset account. It is anticipated that regulations would prevent this type of overstated financial statement expense.

An omission or duplication of an item of income or expense occurs where the item is recognized either not at all or more than once in determining the adjusted net book income of the taxpayer. For example, the exclusion of nontaxable interest income in computing adjusted net book income would constitute an omission of an item of income. The use of unadjusted cost basis in the determination of the gain on the sale of depreciable property in computing adjusted net book income would result in a duplication of an item of expense if depreciation expense had previously been recognized on the property sold.

Congress did not intend otherwise to interfere with the choice of a reasonable accounting method by the taxpayer, to require that certain accounting principles be applied, or to establish the Secretary of the Treasury as an arbiter of acceptable accounting principles.

Congress expected that the Secretary of the Treasury will interfere in the taxpayer's choice of accounting methods only where such methods result in the omission or duplication of items of income or expense. For example, it is anticipated that taxpayers that compute net income for the purpose of their financial statements in accordance with tax accounting rules will be allowed to continue to do so.[20]

Special rules

In the case of a cooperative to which section 1381 of the Code applies, adjusted net book income is reduced by the amount of patronage dividends and per-unit retain allocations that would constitute a deduction under section 1382(b), to the extent such amounts are not otherwise taken into account in determining adjusted net book income.

In the case of an insurance company whose applicable financial statement is the financial statement prepared for regulatory purposes, Congress intended that the measure of adjusted net book income be the amount of net gain from operations after dividends to policyholders and before federal income taxes, inclusive of capital gains and losses.

Certain Alaska native corporations may calculate book income using the asset bases determined under the Alaska Native Claims

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[20] The ability to compute adjusted net book income using tax accounting rules is limited by the requirement that there be no duplications or omissions. For example, a taxpayer computing net book income using tax accounting rules would still be required to include as adjusted net book income interest that is exempt from tax under section 103. Otherwise, an omission of income would result.

Settlement Act. Certain amounts paid to other Alaska native corporations may be treated as expenses for book purposes in the same year as the amounts are deductible for tax purposes.

Adjusted current earnings

In general

For taxable years beginning after 1989, alternative minimum taxable income is increased by 75 percent of the amount by which adjusted current earnings exceeds unadjusted alternative minimum taxable income (before this adjustment), whether alternative minimum taxable income and adjusted current earnings are positive or negative amounts. If unadjusted alternative minimum taxable income exceeds the amount of adjusted current earnings, then alternative minimum taxable income is reduced by 75 percent of such difference. However, such reduction cannot exceed the excess of the aggregate amount by which alternative minimum taxable income has been increased as a result of the adjusted current earnings provision in prior taxable years, less the aggregate amount of reductions taken in prior years.

For example, a calendar year corporation has adjusted current earnings of $400 in 1990, $300 in 1991, and $200 in 1992. Unadjusted alternative minimum taxable income is $300 for each of those years. In 1990, adjusted current earnings exceeds unadjusted alternative minimum taxable income by $100, 75 percent of which ($75) must be included as an additional item of alternative minimum taxable income. In 1992, unadjusted alternative minimum taxable income exceeds adjusted current earnings by $100, creating a potential negative adjustment to alternative minimum taxable income of $75. As the aggregate increases to alternative minimum taxable income for prior years equals $75 (the amount added to alternative minimum tax in 1990) and there are no aggregate reductions, the full amount of the potential negative adjustment will reduce alternative minimum taxable income for 1992.

A positive amount is always considered to be in excess of a negative amount and a smaller negative amount in excess of a larger negative amount. Thus, adjusted current earnings of $20 exceeds alternative minimum taxable income of negative $20 by $40, and $30 (equal to 75% of the excess) would be includible in alternative minimum taxable income. Likewise, alternative minimum taxable income of negative $20 exceeds adjusted current earnings of negative $40 by $20, and $15 (equal to 75% of the excess) could be used to reduce alternative minimum taxable income if not subject to limitation.

Definition of adjusted current earnings

In general, adjusted current earnings requires the same treatment of an item as used for purposes of computing unadjusted alternative minimum taxable income. Thus, for example, deduction disallowances or limitations that apply for purposes of determining regular taxable income and alternative minimum taxable income also apply for purposes of determining adjusted current earnings (e.g., the disallowance of a deduction for bribes and kickbacks (sec. 162(c)) or for penalties (sec. 162(f)), and the limitation on the deduction for policyholder dividends (sec. 808(c)(2)). In the case of exclusion items, however, adjusted current earnings requires the same treatment of an item as used for the computation of regular earnings and profits as computed for purposes of Subchapter C. An exclusion item is an item of income or expense that is included in regular earnings and profits but is never included in the computation of either regular or alternative minimum taxable income (e.g., interest on tax-exempt bonds and the portion of dividends not subject to tax by reason of the dividends received deduction). For this purpose, the fact that an item could eventually be included in alternative minimum taxable income on the liquidation or disposal of a business (or similar circumstances) will not prevent exclusion item treatment. Additionally, adjusted current earnings requires different treatment of certain specifically listed items.

An exclusion item that is income for regular earnings and profits purposes is included in adjusted current earnings. Generally, any item of expense that is not allowable for any year for alternative minimum tax purposes solely because it relates to an exclusion item of income will be allowed in computing adjusted current earnings. Thus, interest on all tax-exempt bonds is included in adjusted current earnings, as well as the costs incurred to carry such tax-exempt bonds. However, if such carrying costs would be limited in the computation of taxable income, even if the income to which they relate is fully taxable, then the costs will be similarly limited for adjusted current earnings. Also, the original issue discount and market discount rules will apply to tax-exempt bonds for purposes of computing adjusted current earnings in the same manner as for taxable bonds.

In determining the amount of an item of deduction or loss allowable for adjusted current earnings, no deduction is allowed for an exclusion item of expense or deduction. Thus, the dividends received deduction generally is not allowed for adjusted current earnings. However, an exception is made for deductions allowed under section 243 or 245 for a dividend qualifying for a 100-percent dividends received deduction if the payor and recipient corporation could not be members of the same affiliated group under section 1504 by reason of section 1504(b), to the extent the payor corporation is subject to Federal income tax.

For example, a foreign sales corporation (FSC) is prohibited from inclusion in its parent's affiliated group, but is subject to federal income tax on only a percentage of its income. The portion of any dividend paid from current earnings and profits to the parent equal to the percentage of the FSC's income that is subject to tax will be eligible for exclusion from adjusted current earnings. In the case of dividends received from section 936 corporations, a similar rule is used for adjusted current earnings. In this case, an exclusion from adjusted current earnings will be allowed for the proportionate part of the dividend from the 936 corporation that equals the percentage of income of the 936 corporation that is not sheltered by the section 936 credit (that is, the percentage of the 936 corporation's income that is not eligible for the 936 credit). For that amount of the dividend that is included in adjusted current earnings, the same rule that applies with regard to the computation of book income (the allowance of a foreign tax credit for a percentage of Puerto Rican withholding and income tax) is provided.

Adjusted current earnings measures pre-tax income without diminution by reason of any distribution made during the taxable year. Thus, the deduction for Federal and foreign income tax expense allowed for regular earnings and profits purposes is not allowed in the computation of adjusted current earnings (except for foreign taxes where the taxpayer elects, or is required, to deduct such taxes rather than claim a credit). Moreover, no deduction is allowed with respect to a dividend paid.

Depreciation is computed for the adjusted current earnings using the slower of the method used for book purposes or the applicable earnings and profits method. The method used for book purposes is the method used in connection with the preparation of the taxpayer's applicable financial statement. What constitutes the taxpayer's applicable financial statement is determined in the same manner as used for determining book income for taxable years beginning in 1987, 1988 and 1989. For property placed in service in taxable years beginning after 1989, the applicable earnings and profits method is straight-line over the ADR midpoint life. For property placed in service after 1986 but before the first taxable year beginning after 1989 and to which the amendments made by section 201 of the Act apply, the applicable earnings and profits method generally provides for depreciation using (1) the adjusted minimum tax basis of property as of the close of the last taxable year beginning before January 1, 1990, (2) the remaining ADR midpoint life of the property at the beginning of the first taxable year beginning after 1989, and (3) the straight line method. For property to which section 168 as in effect on the day before the date of the enactment of this Act applies, the applicable earnings and profits method provides for depreciation using (1) the adjusted regular tax basis of property as of the close of the last taxable year beginning before January 1, 1990, (2) the remaining ADR life as of the beginning of the first taxable year beginning after 1989, and (3) the straight-line method. For property placed in service before 1981, the applicable earnings and profits method is the same method as is used for regular tax purposes.

The determination of whether the method used in connection with the preparation of the taxpayer's applicable financial statement or the applicable earnings and profits method is slower is calculated by comparing the net present values of the deductions provided by each method. In the case of property placed in service in taxable years beginning before 1990, the net present value of deductions is to be determined only with regard to the remaining deductions allowable in taxable years beginning after 1989. In making this determination, the net value of deductions is computed using the same adjusted basis for both methods. It is anticipated that the Secretary of the Treasury will publish interest rates for use in computing the net present value of deductions. In the absence of such published rates, the applicable federal rate (c.f. section 1274(d)) for the period equal to the remaining ADR life of the property may be used.

Intangible drilling and development costs allowable under section 263(c) are capitalized for adjusted current earnings and amortized over the slower of the method used in the preparation of the taxpayer's applicable financial accounting statement or the 60-month period beginning with the month in which production from the well begins. In the case of a taxpayer recovering intangible drilling and development costs through unit of production cost depletion for financial statement purposes, the determination of which method is slower will be done under regulations to be provided by the Secretary of the Treasury, taking into account reasonable estimates of the rate at which the intangible drilling and development costs are recovered or are expected to be recovered for financial accounting purposes. Similar rules apply with respect to mining exploration and development costs in comparing the 120-month period with the method used in the preparation of the taxpayer's applicable financial statement.

No loss is allowed in the determination of adjusted current earnings on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities for the purpose of the adjusted earnings and profits method.

Special rules apply to insurers computing adjusted current earnings. In the case of a life insurance company, the acquisition expenses of any policy, for adjusted current earnings purposes, must be capitalized and amortized in accordance with the method generally required at the time such costs are incurred by the Financial Accounting Standards Board (FASB), or, if the FASB has not published such a method, under guidelines issued by the American Institute of Certified Public Accountants that relate to generally accepted accounting principles. Acquisition expenses of life insurance companies are subject to this treatment on a fresh start basis, i.e., in calculating adjusted current earnings, it is assumed that life insurance acquisition expenses have been treated in the same manner as required under this provision for prior years. Acquisition expenses of property and casualty insurance companies are not subject to this treatment, because the unearned premium reserve deduction of property and casualty insurance companies is reduced by 20 percent (10 percent in the case of certain bond insurance) under the regular tax, as a method of addressing mismatching of deductible acquisition expenses and deferred premium income. In computing adjusted current earnings, the small life insurance company deduction under section 806 and the election for small property and casualty insurance companies to be taxed only on investment income under section 831(b) do not apply.

Inside buildup on a life insurance contract (as determined under section 7702(g)) or on an annuity policy (as determined under section 72(u)(2)) is includible in adjusted current earnings, and a deduction is allowed for that portion of any premium that is attributable to insurance coverage.

In the case of a corporation that has experienced a change of ownership after October 22, 1986 (the date of enactment of the Act), the basis of the property of the corporation may not, for adjusted current earnings, exceed the allocable portion of the purchase price paid for the corporation.

Certain other adjustments required by section 312(n) (i.e., under paragraphs 1 through 6) generally are required in determining adjusted current earnings, subject to the rules regarding dates that apply for such purposes. For example, in the case of a disposition of property occurring in 1990 or thereafter, use of the installment method is not allowable in determining adjusted current earnings even if the use of such method is otherwise allowable for minimum tax purposes.

For the purposes of section 312(n)(1), which requires the capitalization of construction period carrying charges, the "avoided cost method" under section 263A applies to determine the amount of interest allocable to production. under section 312(n)(1), the avoided cost method is intended to apply irrespective of whether application of such method (or a similar method) is required, authorized, or considered appropriate under financial or regulatory accounting principles applicable to the taxpayer. Thus, for example, a utility company must apply the avoided cost method of determining capitalized interest under section 312(n)(1) even though a different method is authorized or required by Statement of Financial Accounting Standards No. 34 or the regulatory authority having jurisdiction over the utility. The growing of timber or other crops is not considered construction under section 312(n)(1).

Congress intended that no inference be drawn from the classification of an item as a specifically listed item as to prior or current treatment for regular earnings and profits purposes or as to whether such a specifically listed item is an exclusion item.

In calculating adjusted current earnings for an affiliated group of corporations filing a consolidated return, appropriate adjustments will be made, as prescribed by the Secretary of the Treasury, to prevent the double inclusion of any item of adjusted current earnings through the operation of the consolidated return regulations or otherwise. The determination of whether a consolidated group is eligible to decrease alternative minimum taxable income as a result of alternative minimum taxable income exceeding adjusted current earnings is expected to be made at the consolidated level.

Separate item allocation

Congress understood that reliance on adjusted earnings and profits would have consequences regarding compliance by taxpayers who already must keep records based on the regular tax and general minimum tax systems. It was intended that the adjusted current earnings and general minimum tax systems be integrated regarding recordkeeping to the maximum extent feasible. Congress anticipated that, before the end of 1989, the Secretary of the Treasury will provide guidance through regulations or rulings regarding such integration. The furtherance of such integration should also be considered in the Treasury study regarding book income and earnings and profits that is mandated under the Act.

Study

Congress directed the Secretary of the Treasury to study and to report regarding the book income and adjusted current earnings provisions, including refinements that may be appropriate (e.g., with regard to the application of the separate item allocation election).

The final report is to be submitted, by January 1, 1989, to the House Committee on Ways and Means and the Senate Committee on Finance.

5. Additional preferences and adjustments applying to corporations

Reserves for losses on bad debts of financial institutions

As under the prior law add-on corporate minimum tax, certain excess reserves of a financial institution to which section 585 or 593 applies are treated as a minimum tax preference. The preference is defined as equal to the excess of the reserve for bad debts deducted by the taxpayer over the amount that would have been allowable had the taxpayer maintained its bad debt reserve for all taxable years on the basis of actual experience.

Capital construction funds of shipping companies

Amounts deposited in a capital construction fund established under section 607 of the Merchant Marine Act of 1936 after 1986 are not deductible, and earnings (including gains and losses) on such income are not excludable, in determining alternative minimum taxable income. In light of this minimum tax treatment, other adjustments required by the Merchant Marine Act of 1936 with respect to amounts withdrawn from a capital construction fund (e.g., reduction in basis under section 607(g)) of such Act) do not apply for minimum tax purposes to the extent that such amounts have already been included in alternative minimum taxable income. For this purpose, amounts deposited in or earned by a capital construction fund before 1987 are treated as withdrawn prior to amounts deposited or earned after 1986.

Special deduction for certain tax-exempt insurance providers

The special deduction under section 333 for certain existing Blue Cross/Blue Shield organizations and for new organizations meeting certain requirements with respect to high risk coverages is not allowed in computing alternative minimum taxable income.

6. Alternative minimum tax itemized deductions for individuals

For minimum tax purposes, no deduction is allowed for any miscellaneous itemized deduction (as defined in section 67(b)), for any State or local taxes which are allowed as an itemized deduction for regular tax purposes, for the standard deduction or for the deduction for personal exemptions.[21] In addition, as under prior law, medical expenses are deductible only to the extent that they exceed 10 percent of a taxpayer's adjusted gross income.

As under prior law, the deduction for investment interest is limited to investment income. However, the investment interest limits for minimum tax purposes are generally conformed to the regular tax limits. Nevertheless, in applying the investment interest limitations of section 163(d), the regular tax phase-in rules do not apply. Also, investment income, for purposes of the minimum tax, includes any tax-exempt interest included in alternative minimum taxable income. Because the passive loss rules are not phased in for minimum tax purposes, the reduction in investment income under section 163(d)(4)(e) during the phase-in period of the passive loss rules does not apply for purposes of the minimum tax.

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[21] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in H.Con.Res. 395 as passed by the House and Senate in the 99th Congress.

Personal interest in not allowed as a deduction in computing the minimum tax. The phase-in rules applicable to the regular tax do not apply. The definition of qualified residence interest is the same as under prior law except that the residence must also qualify for purposes of the regular tax.[22] The Act provides that, for minimum tax purposes, upon the refinancing of a loan, interest paid on the new loan is treated as qualified housing interest to the extent that (1) it so qualified under the prior loan and (2) the amount of the loan was not increased.

Finally the Act provides that a refund of State and local taxes paid, for which no minimum tax deduction was allowed, is not included in alternative minimum taxable income.

7. Tax credits

Minimum tax credit

When a taxpayer pays alternative minimum tax, the amount of such tax paid (i.e., the net minimum tax) generally is allowed as a credit against the regular tax liability (net of other nonrefundable credits) of the taxpayer in subsequent years. However, the minimum tax credit cannot be used to reduce minimum tax liability in subsequent years. The minimum tax credit can be carried forward indefinitely; thus, it is not necessary for the taxpayer to determine which prior year's minimum tax credit is being used in a particular year. The minimum tax credit cannot be carried back.

In the case of an acquisition of assets of a corporation by another corporation to which section 381(a) applies (for example, a statutory merger), any unused minimum tax credits of the acquired corporation are treated as a "tax attribute" that is taken into account by the acquiring corporation. However, for such an acquisition, as well as an acquisition of stock, the availability of the credits may be subject to limitation under the provisions of section 383.

The minimum tax credit is allowed only with respect to net minimum tax liability arising as a result of deferral adjustments and preferences (i.e., adjustments and preferences other than those that result in permanent exclusion of certain income for regular tax purposes). Thus, the amount of the net minimum tax is reduced by the amount of minimum tax liability that would have arisen if the only applicable adjustments and preferences were exclusion items.[23] The exclusion items are those relating to disallowed itemized deductions, depletion, tax-exempt interest, charitable contributions of appreciated capital gain property, and the deduction under section 833 for certain insurance providers.

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[22] It was intended that only interest qualifying as qualified residence interest for purposes of the regular tax would qualify as such for purposes of the minimum tax. A technical correction may be necessary to achieve this result.

[23] It is intended that pre-1987 preferences deferred under old section 56(b) that reduce minimum tax NOL's are not to be treated as exclusion preferences for this purpose.

For purposes of this rule, the book income adjustment that applies to corporations for the years 1987 through 1989 is treated as a deferral item, notwithstanding that some differences between unadjusted alternative minimum taxable income and adjusted net book income may result from exclusion items (such as tax-exempt interest). For taxable years beginning in 1990 or thereafter, items included by reason of the adjustment for adjusted current earnings that otherwise would be permanently excluded from alternative minimum taxable income (e.g., dividends received and tax-exempt interest) are treated as exclusion items.

Consider, for example, the case of married taxpayers filing a joint return, with (1) no regular taxable income, (2) deferral adjustments and preferences in the amount of $350,000, and (3) exclusion adjustments and preferences (including disallowed itemized deductions) in the amount of $250,000. Under the 21 percent alternative minimum tax rate, and in light of the phaseout of the $40,000 exemption amount, minimum tax liability would equal $126,000. However, if the taxpayers had had only exclusion adjustments and preferences, minimum tax liability would have equalled $49,350 (21 percent of $250,000 as reduced by $15,000, which is the portion of the $40,000 exemption amount remaining after application of the phaseout). Thus, the amount of minimum tax available as a carryforward credit would be $76,650 ($126,000 less $49,350).

In some cases, a taxpayer's accumulated minimum tax credits from prior taxable years may be reduced even though such credits are not used to reduce regular tax liability (or may be reduced to a greater extent than such credits are used to reduce such liability). This occurs in years where both of the following circumstances are present: (1) taking into account solely the deferral items, alternative minimum taxable income is less than regular taxable income, and (2) due to the exclusion items, the taxpayer would incur minimum tax liability for the year if alternative minimum taxable income were treated as equal to regular taxable income with respect to the deferral items.

For example, assume that an individual's regular tax liability is equal to tentative minimum tax in a year in which regular taxable income is $100,000 greater than alternative minimum taxable income with respect to deferral items.[24] The negative adjustment to minimum taxable income has had the effect of reducing tentative minimum tax liability by $21,000 (assuming that the taxpayer is above the phase-out range of the minimum tax exemption amount). Thus, the minimum tax credit is reduced by $21,000.

Foreign tax credit

Under the Act, minimum tax liability is defined as the excess of the tentative minimum tax (i.e., 21 percent, or 20 percent in the case of a corporation, of the excess of alternative minimum taxable income over the exemption amount, reduced by the specially computed foreign tax credit using the minimum tax base) over the regular tax (i.e. regular tax liability reduced by the foreign tax credit). The foreign tax credit is thus, with certain modifications, allowable for purposes of the alternative minimum tax. These modifications involve separate application, for minimum tax purposes, of the section 904 limitations on the amount of the credit, to reflect the differences between regular taxable income and alternative minimum taxable income.

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[24] This can happen, for example, upon the sale of an item of depreciable property with respect to which allowable regular tax depreciation exceeded allowable minimum tax depreciation, For taxable years prior to the year of the sale, by $100,000. since minimum tax basis for the item exceeds regular tax basis by $100,000, the taxpayer has $100,000 more of gain for regular tax than for minimum tax purposes.

For example, to the extent that preferences allocable to U.S. source income alter the ratio of foreign taxable income to worldwide income for minimum tax purposes, the application of section 904 may lead to different results under the regular and the alternative minimum taxes, respectively. In light of these differences, taxpayers must separately keep track of the amount of foreign tax credit carryforwards allowable for regular and for minimum tax purposes.

If a corporation includes any adjusted net book income in its alternative minimum taxable income, for purposes of applying section 904, the percentage of such income that is treated as from sources within or outside the United States is the same as the percentage applying with respect to all other alternative minimum taxable income of the taxpayer. Thus, in effect, the book income preference does not result in any change in the percentage applying for purposes of the alternative minimum tax section 904 limitation. A similar rule applies in assigning the amount of adjusted net book income that is treated as foreign source to the separate foreign tax credit limitations.

For taxable years beginning in 1990 or thereafter, items included in alternative minimum taxable income by reason of the preference for adjusted current earnings are sourced, for purposes of the section 904 limitation, on an item-by-item basis. Assume, for example, that a taxpayer has includable adjusted current earnings of $10, $6 of which results from owning tax-exempt bonds that are not otherwise subject to the minimum tax, and $4 of which results from the application of slower book depreciation to property producing foreign-source income. Of the $10 included by reason of the adjusted current earnings preference, $6 is treated as from sources within the United States, and $4 is treated as foreign source income.

In addition to being limited by section 904, use of the foreign tax credit is limited for minimum tax purposes by a rule designed to prevent U.S. taxpayers with substantial income from using the foreign tax credit, along with net operating losses and investment tax credits, to reduce U.S. tax liability by more than 90 percent. This rule is described more fully below. Any foreign tax credits that are disallowed under this rule are treated, for carryover purposes, like credits disallowed by reason of section 904. The rule, like the limitation under section 904, is applied prior to comparing the amount of the taxpayer's minimum tax liability with the amount of its regular tax liability.

With regard to years prior to the effective date of the corporate alternative minimum tax, rules apply like those applying in 1982 upon the enactment of the individual alternative minimum tax. Thus, in the case of a corporation, pre-effective date regular tax foreign tax credits carried forward to 1987 are treated as minimum tax foreign tax credit carryforwards, and minimum tax foreign tax credits are reduced by the amount of any foreign tax credits carried back, for regular tax purposes, to years prior to 1987. Similarly, a taxpayer's election to treat foreign taxes as credits for regular tax purposes rather than deductions is controlling for minimum tax purposes as well.

Incentive tax credits

General rule

Nonrefundable credits other than the minimum tax credit generally are accorded treatment having the same effect as the rules applying under the prior law alternative minimum tax on individuals. However, the rules were revised in one technical respect in the interest of simplicity. Under prior law, nonrefundable credits could be claimed against the regular tax even if they provided no benefit due to the minimum tax (i.e., they reduced regular tax liability to less than the amount of minimum tax liability that was due in any case). To the extent that the credits provided no benefit due to the minimum tax, however, they were allowed as carryovers to other taxable years.

Under the Act, such credits generally can be claimed in the first place only to the extent that the regular tax liability exceeds the tentative minimum tax liability. They cannot be claimed to the extent that they would reduce regular tax liability to the amount of tentative minimum tax liability. Credits that are disallowed by reason of this restriction are allowed as carryovers to other taxable years, under the generally applicable rules for credit carryovers.

Where no minimum tax is due and the minimum tax does not limit the use of incentive credits, the taxpayer is not required to file with his or her tax return a form showing minimum tax computations. For example, a taxpayer with $100 of regular tax liability (disregarding incentive credits), a targeted jobs tax credit in the amount of $10, and whose tentative minimum tax equalled less than $90, would not be required to file a minimum tax form with the Internal Revenue Service.

Exception for regular investment tax credits

As an exception to the general rule denying the use of incentive credits against the minimum tax, regular investment tax credits are permitted, in effect, to reduce minimum tax liability by 25 percent.[25] Under this exception, such credits can be claimed to the extent the regular tax liability (net of credits with a lower Code section number) exceeds 75 percent of tentative minimum tax liability, rather than the full amount of such liability. Moreover, such credits can instead be used in an amount equal to 25 percent of the taxpayer's tentative minimum tax liability for the year, where this results in permitting a greater amount of such credits to be used for the year (i.e., tentative minimum tax liability is greater than regular tax liability).[26]

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[25] Certain other transitional rules also apply with regard to the minimum tax treatment of investment tax credits. Where relevant in applying these transitional rules, the megawattage of an electric generating unit is determined with reference to the Summary Information Report (NUREG-0871, Vol. No. 4, Issue Date: October 1985), published by the U.S. Nuclear Regulatory Commission.

In applying this rule, the taxpayer maintains a single investment tax credit account for both regular and minimum tax purposes. The amount of remaining investment tax credit carryovers is reduced, for both regular and minimum tax purposes, by the amount by that such credits are allowed for the taxable year (without regard to whether the taxpayer is liable for the regular or the minimum tax).

The allowance of the additional investment tax credit does not affect the computation of the minimum tax credit. For example, where regular tax liability exceeds tentative minimum tax liability, no minimum tax credit arises by reason of the reduction of regular tax liability, net of investment tax credits, to less than 100 percent of tentative minimum tax liability, in as much as there is no minimum tax imposed in that year.

For example, assume that a corporation has a regular tax liability of $10 million and a tentative minimum tax liability of $4 million. The corporation can use up to $7 million of investment tax credits, reducing its net tax liability to $3 million. This net liability does not give rise to any minimum tax credit in future years since there is no minimum tax imposed by section 55 in that year. In addition, since investment tax credits are used before minimum tax credits, and since minimum tax credits cannot reduce regular tax liability to less than the tentative minimum tax liability, the corporation cannot use any minimum tax credits from prior taxable years (assuming that it has available at least $6 million of investment tax credits.)[27]

Where the tentative minimum tax liability exceeds regular tax liability, the allowance of the additional investment tax credit does not result in a corresponding reduction in the amount of the minimum tax credit allowable in later years. The reason for this rule is that, if the minimum tax credit was treated, instead, as reduced in consequence of the use of investment tax credits to offset minimum tax liability, each $1 of benefit to a taxpayer by reason of the special rule for investment tax credits could, in subsequent years, give rise to a $2 increase in tax liability (by reducing both the available minimum tax credits and the investment tax credit carryforward by $1).

Assume that a corporation has a regular tax liability of zero and a tentative minimum tax liability of $4 million. The corporation can use up to $1 million of investment tax credits, reducing its net tax liability to $3 million. The corporation's adjusted net minimum tax for the year is $4 million and therefore the minimum tax credit allowable in future years is increased by $4 million in the event that all of its preferences are deferral preferences, since the adjusted minimum tax is measured without regard to the use of the investment tax credit.

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[26] A technical correction may be appropriate to clarify the computation of the credit limitation (under section 38(c)(3)) where the taxpayer has both regular investment tax credits and other credits included in the general business credit.

[27] In the absence of sufficient other tax credits, the corporation could use minimum tax credits arising by reason of the adjusted net minimum tax imposed in prior taxable years to reduce its net tax liability to not less than $4 million.

Assume that instead the corporation has a regular tax liability of $3.5 million and a tentative minimum tax liability of $4 million. The corporation can use up to $1 million of investment tax credits, reducing its net tax liability to $3 million. The corporation's adjusted net minimum tax for the year is $500,000 and therefore the minimum tax credit allowable in future years is increased by that amount, in the event that all of its preferences are deferral preferences.

Allowance of the regular investment tax credit is further limited by the rule, described more fully below, generally preventing the use of such credits, along with foreign tax credits and net operating losses, to reduce the otherwise applicable minimum tax liability (i.e. the amount determined under section 55(b)(1)(A) without regard to the net operating deduction) by more than 90 percent. Thus, for example, assume that a taxpayer would have no regular tax liability, and a tentative minimum tax liability of $10 million, in the absence of foreign tax credits, net operating losses, and investment tax credits. As described below, foreign tax credits and net operating losses could not be used to reduce the net tentative minimum tax liability to less than $1 million. To the extent that such losses and foreign tax credits did not so reduce minimum tax liability, investment tax credits could then be used (to the extent allowable consistently with the rules described above) to reduce such liability to $1 million.

Treatment of income eligible for section 936 credit

In the case of a corporation that is eligible for the possessions tax credit under section 936, alternative minimum taxable income (including the preference for book income or adjusted current earnings) shall not include any amount which meets the requirements of section 936(a)(1)(A) or (B).[28] A corporation that qualifies for the section 936 credit may nonetheless be subject to the minimum tax with respect to income not qualifying for the credit.

8. Net operating losses

Under the Act, special rules apply for net operating losses. These rules generally are the same as the prior law rules with respect to the alternative minimum tax for individuals, except that, as described more fully below, the net operating loss deduction may not exceed 90 percent of the taxpayer's alternative minimum taxable income for the year (determined without regard to the NOL deduction).

For purposes of the alternative minimum tax, net operating loss deductions are determined by using a separate computation of alternative minimum tax net operating losses and loss carryovers. Generally, this computation takes into account the differences between the regular tax base and the alternative minimum tax base.

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[28] As discussed above, a dividend paid by a section 936 corporation to its parent corporation may be included in alternative minimum taxable income, by increasing the amount of the parent's adjusted net book income or adjusted current earnings. In such a case, a certain amount of foreign taxes paid with respect to such dividends and paid by the 936 corporation that are treated as paid by the parent (under the principles of section 902) are allowed to be taken as a foreign tax credit for alternative minimum tax purposes.

The amount of the net operating loss (under section 172(c)) for any taxable year, for purposes of the alternative minimum tax, generally is computed in the same manner as the regular tax net operating loss, with two exceptions. First, the items of tax preference arising in that year are added back to taxable income (or, as with depreciation, adjustments relating to those items are made). Second, for individuals, only those itemized deductions (as modified under section 172(d)) allowable in computing alternative minimum taxable income are taken into account. In computing the amount of deduction for years other than the year of the loss (i.e., carryover years), the recomputed loss is deducted from the alternative minimum taxable income (as modified under section 172(b)(2)(A)) in the carryover year (whether or not the taxpayer is subject to the minimum tax in that year).[29]

Where, in the case of a corporation, an NOL arises in a taxable year beginning after December 31, 1986, and is carried to another taxable year, the NOL must be reduced by the corporation's taxable income for any taxable year beginning before 1987 to which the NOL was carried back under the regular tax system, notwithstanding that the alternative minimum tax was not applicable in those years. Thus for example, assume that a corporation had an alternative minimum tax NOL of $100 in calendar year 1987, and had taxable income (before application of NOL carrybacks from taxable years beginning after 1986) of $25 in 1984, $40 in 1985 and $10 in 1986. That corporation's minimum tax NOL deduction in 1988 attributable to the loss in 1987 would be $25 ($100 NOL reduced by the $75 of taxable income).

As an example of the functioning of the rule, if in year one a taxpayer has $20,000 of income and $35,000 of deductions in computing taxable income, of which $10,000 are preference items or adjustments, the alternative minimum tax net operating loss for the year is $5,000. Thus, in any subsequent (or prior) year to which the loss may be carried, a $5,000 net operating loss deduction is allowed to reduce altenative minimum taxable income.

Assume that, in year two, the taxpayer has $20,000 of alternative minimum taxable income (without regard to the net operating loss deduction). The taxpayer reduces his or her alternative minimum taxable income to $15,000 by the minimum tax net operating loss deduction. The net operating loss deduction for the regular tax is not affected by this computation (i.e., the taxpayer has a loss carryover of $15,000 from year one to be used under the regular tax).

For corporations, a transition rule generally allows, for purposes of the alternative minimum tax, all pre-effective date regular tax net operating losses to be carried forward as minimum tax NOLs to the first taxable year for which the tax, as amended under the Act, applies (and to subsequent years until used up). For individuals, prior law is retained with respect to the calculation of alternative minimum tax net operating losses for such years.

An adjustment is required in the case of a corporation that, as of the end of the last taxable year beginning before January 1, 1987, had a deferral of add-on minimum tax liability for a year prior to 1987, under section 56(b), due to certain net operating losses. For such a corporation, no add-on minimum tax liability will be imposed after 1986, but the alternative minimum tax net operating loss carried to the first taxable year of the corporation beginning after December 31, 1986, is reduced by the amount of the preferences that gave rise to the liability.

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[29] Net operating losses that are not allowed in a particular taxable year because they exceed 90 percent of alternative minimum taxable income for the year may be carried over to other taxable years, in accordance with the rules of section 172(b).

In light of the parallel nature of the regular tax and minimum tax systems, any limitations applying for regular tax purposes to the use by a consolidated group of NOLs or current year losses (e.g., section 1503) apply for minimum tax purposes as well. Moreover, an election under section 172(b)(3)(C) to relinquish the carryback period applies for both regular tax and minimum purposes.

9. Limitation on the use of foreign tax credits, net operating losses, and investment tax credits

Under the Act, limitations apply to prevent the use of foreign tax credits and regular investment tax credits to offset more than 90 percent of the tentative minimum tax liability (determined without regard to the NOL deduction). Moreover, as described above, the alternative minimum tax net operating loss deduction may not exceed 90 percent of the taxpayer's alternative minimum taxable income for the year determined without regard to the net operating loss deduction.

Foreign tax credits cannot exceed the excess of the pre-foreign tax credit tentative minimum tax over 10 percent of such amount (determined without regard to the NOL deduction). For example, assume that in 1987 a corporation has $10 million of alternative minimum taxable income. In the absence of net operating losses or foreign tax credits, the taxpayer's tentative minimum tax liability would equal $2 million. Accordingly, the alternative minimum tax foreign tax credit cannot exceed the amount by which the taxpayer's pre-foreign tax credit tentative minimum tax exceeds $200,000.

Regular investment tax credits are likewise subject to a rule preventing their use, in conjunction with foreign tax credits, to offset more than 90 percent of minimum tax liability (determined without regard to the NOL deduction). Under this rule, 10 percent of the taxpayer's tentative minimum tax liability (as determined without regard to net operating losses and foreign tax credits) functions, in effect, as a floor, limiting the use of otherwise allowable investment tax credits. Notwithstanding the general rule for regular investment tax credits described above (or any narrower transition rule applying to the use of such credits in relation to the minimum tax), such credits cannot be used in a taxable year to the extent that they would reduce the amount of tax payable by the taxpayer (whether under the regular tax or the minimum tax) to less than this floor.[30]

For example, assume that a corporation has $10 million of pre-NOL alternative minimum taxable income for the year, a $7 million net operating loss deduction, $350,000 of minimum tax foreign tax credits, and $200,000 of regular investment tax credits. In the absence of the net operating loss deduction, foreign tax credits and regular investment tax credits, tentative minimum tax liability would equal $2 million. The NOL deduction, the foreign tax credit and the investment tax credit cannot reduce the net income tax imposed to less than 10 percent of this amount, or $200,000. Net operating losses and foreign tax credits can be used in full, and reduce tentative minimum tax liability to $250,000 (20 percent of $3 million, reduced by the $350,000 foreign tax credits). Assuming that regular tax liability is less than tentative minimum tax liability, only $50,000 of regular investment tax credits can be used (giving rise to an investment tax credit carryforward of $150,000).[31]

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[30] A technical correction may be needed so that the statute properly reflects this intent. Such a correction was included in H.Con.Res. 395 as passed by the House and Senate in the 99th Congress.

10. Regular tax elections

In the case of certain expenditures that would give rise to a minimum tax preference if treated under the rules generally applying for regular tax purposes, the taxpayer may make a "normative election," i.e., elect to have the minimum tax rule for deducting the expenditure apply for regular tax purposes. The expenditures to which this rule applies are the following: circulation expenditures, research and experimental expenditures, intangible drilling costs, and mining development and exploration expenditures.[32] Elections can be made "dollar-for-dollar"; thus, for example, a taxpayer who incurs $100,000 of intangible drilling costs with respect to a single well may elect normative treatment for any portion of that amount.

To the extent that such an election applies, the item to which it applies is treated for all purposes, under both the regular and the minimum tax, pursuant to the election. No other deduction is allowed for the item to the extent that such an election applies.

An election made under this rule may be revoked only with the consent of the Secretary. Elections may be made at such time and in such manner as the Secretary by regulations prescribes. In the case of a partnership or S corporation, an election can be made separately by any partner (or shareholder) with respect to such individual's allocable share of any expenditure.

11. Other rules

The Act also contains certain miscellaneous rules affecting the application of the alternative minimum tax. For example, corporations are required to make estimated tax payments with respect to liability under the alternative minimum tax.

Rules are also provided with respect to the application of Code sections suspending losses, such as sections 465, 704(d), 1366(d), and other sections specified in regulations. Since deductions, or the basis of property, relevant to the application of these sections may differ for regular and minimum tax purposes, respectively, it is necessary to recompute, for minimum tax purposes, the amounts that are suspended and carried forward.

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[31] In the absence of this rule, the general transitional rule for investment tax credits would permit the taxpayer to use investment tax credits in the amount of $62,500, i.e., 25 percent of tentative minimum tax liability (as determined after the use of net operating losses and foreign tax credits).

[32] As described in title II of this part, normative elections are also allowed with respect to depreciation.

For example, assume that a taxpayer has property with respect to which he is at risk in the amount of $100. For regular tax purposes, deductions relating to the property equal $110 in year 1 and $80 in year 2. For minimum tax purposes, such deductions equal $90 in year 1 and $90 in year 2. For regular tax purposes, section 465 permits the taxpayer to deduct $100 in year 1 and zero in year 2, and the taxpayer has $90 of suspended deductions as of the end of year 2. For minimum tax purposes, the taxpayer is allowed to deduct $90 in year 1 and $10 in year 2, and has $80 of suspended deductions as of the end of year 2.

The Act provides that in the case of an estate or trust, the alternative minimum taxable income of the estate or trust and its beneficiaries shall be determined under the rules generally applicable to trusts and estates by taking into account the adjustments provided in the minimum tax.

The Act provides rules for allocating items that are treated differently for regular and minimum tax purposes, respectively, are also provided with respect to common trust funds, regulated investment companies, and real estate investment trusts.[33] Moreover, rules are provided relating to certain technical issues such as short taxable years and the application of exemption amounts with respect to companies filing consolidated returns.

The Act provides that except as specifically provided in the case of certain preferences such as mining exploration and development costs, for purposes of the corporate minimum tax, the amount of a preference is measured after the application of section 291 (relating of the cutback of certain corporate preferences). Thus, for example, to the extent that a taxpayer's bad debt reserve or percentage depletion for coal or iron ore is reduced for regular tax purposes pursuant to section 291, the amount of such reduction is not "double-counted" by being treated as a minimum tax preference.

Under the Act, the application of the tax benefit rule to the minimum tax is within the discretion of the Secretary of the Treasury. Relief from either the regular or the minimum tax, when the source of the taxpayer's tax liability changes, between taxable years, from one system to the other, is not appropriate solely by reason of the fact that a taxpayer has received no benefit under one of the systems with respect to a particular item. Congress both intended that the regular and minimum taxes constitute separate and parallel tax systems, and anticipated that the source of some taxpayers' liability would change from year to year. Relief from the possible adverse impact of switching from one system to the other (e.g., the denial of deductions with respect to which there are timing differences as between the two systems) was intended to be provided by means of the minimum tax credit, along with the use of adjustments that give rise, in effect, to "negative preferences" with respect to items such as depreciation. Thus, application of the tax benefit rule in this context is not necessary, although the Treasury may, at its discretion, identify particular circumstances where such exercise is appropriate.

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[33] For example, if a RIC or REIT distributes all its pre-dividend taxable income in each taxable year, it is intended that the minimum tax adjustments and preferences be apportioned to the shareholders and beneficiaries since the adjustments and preferences either reduced or increased the entity's taxable income and therefore the amount of the dividend. Where any shareholder or beneficiary incurs a minimum tax attributable to deferral items, that shareholder or beneficiary may use the minimum tax credit in future years to offset regular tax under usual rules. Where the RIC or REIT distributes more or less than its taxable income in a taxable year, the Treasury Department is to prescribe regulations providing rules for apportioning the preferences and adjustments.

Effective Date

These provisions apply to taxable years beginning after December 31, 1986.

Revenue Effect

With respect to individuals, the provision is estimated to increase fiscal year budget receipts by $848 million in 1987, $3,904 million in 1988, $2,251 million in 1989, $862 million in 1990, and $334 million in 1991.

With respect to corporations, the provision is estimated to increase fiscal year budget receipts by $3,087 million in 1987, $5,378 million in 1988, $5,072 million in 1989, $4,466 million in 1990, and $4,155 million in 1991.

TITLE VIII—ACCOUNTING PROVISIONS

A. Limitations on the Use of the Cash Method of Accounting (Sec. 801 of the Act and sec. 448 of the Code) [1]

Prior Law

Taxpayers using the cash recipts and disbursement method of accounting (the "cash method") under prior and present law generally recognize items of income when actually or constructively received and items of expense when paid. Tax shelters using the cash method of accounting generally may not recognize items of expense prior to economic performance. Taxpayers using an accrual method of accounting generally accrue items as income when all the events have occurred that establish the right to receive the income and the amount of income can be determined with reasonable accuracy. Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to the time of economic performance.

Under prior law, taxpayers could generally elect to use any method of accounting, such as the cash method, an accrual method, or combinations of methods so long as the method clearly reflected income and was regularly used in keeping the taxpayer's books. However, under prior and present law, taxpayers for whom the production, purchase, or sale of merchandise is a material income producing factor are required to keep inventories and to use an accrual method of accounting with respect to inventory items (sec. 471). Also, prior and present law requires certain corporations engaged in agricultural activities with gross receipts exceeding $1 million to use an accrual method of accounting (sec. 447).

Reasons for Change

In general

The Congress believed that the cash method of accounting frequently fails to reflect accurately the economic results of a taxpayer's trade or business over a taxable year. The cash method of accounting recognizes items of income and expense based on the taxable year in which funds are received or disbursed. This may result in the recognition of income and expense items without regard to the taxable year in which the economic events giving rise to the items occurred and a potential mismatching of income with related expenses. For these reasons, the cash method generally is not in accord with generally accepted accounting principles. The cash method also produces a mismatching of income and deductions when all parties to a transaction use different methods of accounting.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 902; H. Rep. 99-26, pp. 604-609; H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 321; S. Rep. 99-313, pp. 118-119; and H. Rep. 99-841, Vol. II, (September 18, 1986), pp. 285-289 (Conference Report).

Exceptions

On the other hand, the Congress also recognized that the cash method generally is a simpler method of accounting and that simplicity justifies its continued use by certain types of taxpayers and for certain types of activities. The Congress believed that small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher costs of compliance which will result if they are forced to change from the cash method. Similarly, the Congress believed that farming businesses (other than farming tax shelters and certain corporate farming businesses required to use an accrual method under present law) should be able to continue to use the cash method in order to avoid the complexities required to account for growing crops and livestock under other acceptable methods of accounting.

Finally, the Congress believed that individuals, whatever the size of their activities, should be able to continue to use the cash method. Individuals, especially individuals engaged in professional activities, traditionally have used the cash method of accounting in the operation of their trades or businesses. Similarly, the Congress believed that personal service corporations and entities where the income is taxed at the individual level (such as partnerships and S corporations) traditionally have used the cash method of accounting in the operation of their trades or businesses and, accordingly, should be eligible for the continued use of the cash method of accounting.

Tax shelters

The Congress believed that tax shelters should not be allowed to use the cash method of accounting, regardless of the form in which business is conducted and regardless of whether or not the tax shelter satisfies one or more of the exceptions that would otherwise allow use of the cash method. In choosing to conduct business as a tax shelter, the entity has indicated a sufficient sophistication in the use of the tax laws to justify requiring the use of a more difficult method than the cash method. In addition, the use of the cash method itself may assist the tax shelter in obtaining unwarranted benefits under the tax laws.

Nonaccrual of certain items unlikely to be collected

The Congress was concerned that certain taxpayers could be required to accrue income from services with respect to amounts they are unlikely to collect. Where a taxpayer includes accounts receivable, which do not bear interest or a late charge in its income, accrual in income of the full sales price immediately, combined with a bad debt deduction allowed at a later time, will overstate the taxpayer's income because the present value of the bad debt deduction will be less than the present value of the accrued income. Accordingly, the Act provides that taxpayers on an accrual method will not be required to accrue income attributable to that portion of their accounts receivable derived from the performance of services which are unlikely to be collected. This exception does not apply where the accounts receivable bear interest or a late charge because the face amount of the obligation bearing interest or late payment charges is the present value of the accrued income and, consequently, the present value of the accrued income will not exceed the present value of the later bad debt deduction.

Explanation of Provision

In general

The Act generally provides that the cash method of accounting may not be used by any C corporation, by any partnership that has a C corporation as a partner, or by a tax-exempt trust with unrelated business income. Exceptions are made for farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less for all prior taxable years (including the prior taxable years of any predecessor of the entity). The Act also provides that the cash method of accounting may not be used by any tax shelter.

In determining whether a partnership has a C corporation as a partner, a C corporation that is a qualified personal service corporation (discussed below) is treated as an individual. Thus, partnerships qualifying to retain the use of the cash method are those partnerships in which all of the partnership interests are held by individuals, qualified personal service corporations, S corporations, or other partnerships qualifying to retain the cash method.

The Congress denied the use of the cash method of accounting to a partnership that has a C corporation as a partner in order to prevent entities that themselves could not use the cash method from obtaining the advantages of the cash method through investments in partnerships. Accordingly, if a C corporation which is not a qualified personal service corporation is the beneficial owner of a partnership interest, the partnership may not use the cash method of accounting, unless it meets one or more of the exceptions provided. For example, if two C corporations are partners in a partnership that is in turn a partner in another partnership, neither of the partnerships are intended to be allowed to use the cash method of accounting.[2]

The use of a hybrid method of accounting which records some, but not all, transactions using the cash method is considered the same as the use of the cash method for these purposes. Any change from the cash method necessitated by the provision is treated as a change in accounting method, initiated by the taxpayer with the approval of the Secretary of the Treasury. The provision does not change the rules of present law relating to what accounting methods clearly reflect income or the authority of the Secretary of the Treasury to require the use of an accounting method that clearly reflects income.

Qualified personal service corporations

A qualified personal service corporation is a corporation that meets both a function test and an ownership test. The function test is met if substantially all the activities of the corporation are the performance of services in the field or fields of health, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts or consulting.

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[2] A technical correction may be needed to reflect this intention.

The ownership test is met if substantially all (i.e., 95 percent) of the value of the outstanding stock in the corporation is owned, directly or indirectly, by employees performing services for the corporation in connection with the qualified services performed by the corporation, retired individuals who performed such services for the corporation or its predecessor(s), the estate of such an individual, or any other person who acquired stock by reason of the death of such an employee (for the 2-year period beginning with the death of such employee).

For the purpose of applying the ownership test, stock owned by a partnership, an S corporation or a qualified personal service corporation will be considered as owned by its partners or shareholders. In applying the ownership test, the applicable community property laws of any State are to be disregarded, stock held by any plan described in section 401(a) that is exempt from tax under section 501(a) is treated as held by the employees of the entity and, at the election of the common parent of an affiliated group, all members of such affiliated group may be treated as a single entity for the purpose of applying the ownership test if substantially all of the activities of such affiliated group involve the performance of services in the same qualified field.[2a]

Any other ownership of stock as a result of any attribution rule of the Code is to be disregarded. For example, stock held by a father is not to be attributed to his children. Thus, the ownership test would not be considered to be met if nonemployee-children owned more than 5 percent of the stock, despite the fact that their father might be an employee of the corporation.

Farming businesses

The Act provides that, for the purpose of determining whether an entity is engaged in a farming business, the definition of farming shall include the raising or harvesting of trees (including evergreen trees that are not subject to the capitalization provisions of section 263A).

Gross receipts test

An entity is considered to meet the gross receipts test and, therefore, is eligible to use the cash method of accounting, if the entity had "average annual gross receipts" of $5 million or less for all prior taxable years (including the prior taxable years of any predecessor entity) beginning after December 31, 1985. "Average annual gross receipts" are determined by averaging the gross receipts of the three taxable year period ending with such prior taxable year.

For example, a calendar year entity had gross receipts of $4 million in 1984, $5 million in 1985, $6 million in 1986 and $7 million in 1987. Average annual gross receipts are $5 million for 1986 and $6 million for 1987. In calendar year 1987, the entity is not prohibited from using the cash method, since it had "average annual gross receipts" of $5 million or less for all prior taxable years beginning after December 31, 1985 (i.e., 1986). In 1988, the entity may not use the cash method (unless it meets one of the other exceptions) since "average annual gross receipts" for a prior taxable year (1987) exceed $5 million.

[2a] A technical correction may be needed to reflect this intention.

Any taxable year included in the average annual gross receipts calculation which is a year of less than 12 months must be annualized. If the entity (or any predecessor entity) was not in existence for all three of the taxable years to be used in the calculation, average annual gross receipts is calculated of the period during which such entity (or predecessor) was in existence.

In determining whether a taxpayer has average annual gross receipts in excess of $5 million, the gross receipts of all related entities are aggregated if such entities would be treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, regardless of whether the entities have any employees.

In determining the gross receipts of entities aggregated under this rule, intercompany receipts of such entities are to be excluded.

Accrual of service income

A taxpayer is not required to accrue as income any amount to be received for the performance of services that, on the basis of experience, will not be collected, as long as unpaid balances do not bear interest or result in a late payment charge. The offering of a discount for early payment of an amount billed does not result in the balance bearing interest or a late charge if the full amount billed is accrued as income and the discount for early payment recorded as an adjustment to income in the year the payment is made.

The amount of accruals that, on the basis of experience will not be collected is equal to the total amount of the accrual, multiplied by a fraction whose numerator is the total amount accrued and determined not to be collectible within the most recent five taxable years of the taxapayer, and whose denominator is the total amount of such accruals within the same five year period. If the taxpayer has not been in existence for the prior five taxable years, the portion of such five year period which the taxpayer has been in existence is to be used.

For example, an accrual-basis taxpayer has accrued $100,000 of income for the performance of services during the most recent five taxable years. Of the $100,000 that has been accrued, $1,000 has been determined to be uncollectible. The amount, based on experience, which is not expected to be collected is equal to 1 percent ($1,000 divided by $100,000) of any accrued income for the performance of services that does not bear interest or a late charge, and that is not collected by the close of the taxable year.

A taxpayer that has not recognized income on amounts not expected to be collected must recognize additional income in any taxable year in which payments on amounts not recognized are received. If an amount that would otherwise be accrued as income is determined to be partially or wholly uncollectible, no portion of the loss arising as a result of such determination, that was not recognized as income at the time the receivable was created, is deductible.

The Congress intended that the Secretary of the Treasury be allowed to provide a periodic system of accounting for accruals that, on the basis of experience, will not be collected if the periodic system results in the same taxable income as would be the case if each accrual were recorded separately.

Tax shelters

The Act provides that the cash method of accounting may not be used by any tax shelter. For this purpose, a tax shelter is defined in the same manner as under section 461(i) of prior and present law. Thus, a tax shelter is (a) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale, (b) any syndicate within the meaning of section 1256(e)(3), or (c) any tax shelter within the meaning of section 6661(b)(2)(C)(ii). In the case of an enterprise engaged in the trade or business of farming, a tax shelter is (a) any tax shelter within the meaning of section 6661(b)(2)(C)(ii) or (b) a farming syndicate within the meaning of section 464(c).

The denial of the use of the cash method of accounting to tax shelters applies whether or not the tax shelter is a C corporation. Also, the exceptions to the general rule for farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less do not apply in the case of tax shelters.

A tax shelter may not take advantage of the recurring item exception under section 461(h)(3) to the rule requiring economic performance before an accrual basis taxpayer may deduct an item of expense. In the case of a tax shelter, however, economic performance with respect to the drilling of an oil and gas well will be considered to have occurred if the drilling of the well commences within 90 days of the close of the taxable year.

Certain pre-effective date transactions

Taxpayers may elect to continue to report income from loans, leases, certain real property contracts, and transactions with related parties entered into before September 25, 1985, using the cash method. This rule applies to tax shelters as well as other entities.

Tax-exempt organizations

The Act provides that a tax-exempt organization that is organized as a trust is treated as a corporation with respect to any of its unrelated business income. Therefore, where a tax-exempt trust has gross receipts from its unrelated business activities in excess of $5 million, the unrelated business taxable income of that trust cannot be computed on the cash method of accounting. Similarly, in the case of a tax-exempt organization organized as a corporation, the Congress intended to require the use of an accrual method only with respect to the unrelated business taxable income of such an organization.[3]

Effective Date

The provision is effective for taxable years beginning after December 31, 1986. Any change from the cash method required by this provision is treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of such change generally shall be taken into account over a period not to exceed four years. It is the intent of the Congress that this apply to all changes resulting from the provision, including any changes necessitated by the rule that certain accrual taxpayers, including taxpayers presently on an accrual method of accounting, need not recognize income on amounts statistically determined not to be collectible.

In the case of a hospital, the adjustment shall be taken into account ratably over a ten-year period. For this purpose, a hospital is a taxable or tax-exempt institution that—

(1) Is accredited by the Joint Commission of Accreditation of Hospitals (JCAH), or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAH;

(2) Is primarily used to provide, by or under the supervision of physicians, to inpatients diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons;

(3) Has a requirement that every patient be under the care and supervision of a physician; and

(4) Provides 24-hour nursing services rendered or supervised by a registered nurse and has a licensed practical nurse or registered nurse on duty at all times.

In order to qualify as a hospital, an institution is not required to be owned by or on behalf of a governmental unit or by a 501(c)(3) organization or operated by a 501(c)(3) organization.

The Congress intended that the timing of the section 481 adjustment (other than for a hospital) generally will be determined under the provisions of Revenue Procedure 84-74, 1984-2 C.B. 736. In addition, the Congress intended that (1) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; (2) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized in taxable income ratably throughout the year in question; and (3) the timing of a negative section 481 adjustment shall be determined as if the adjustment were positive.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $290 million in 1987, $595 million in 1988, $631 million in 1989, $646 million in 1990, and $650 million in 1991.

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[3] A technical correction may be needed to reflect this intention.

B. Simplified Dollar Value LIFO Method for Certain Small Businesses (Sec. 901 of the Act and sec. 474 of the Code) [4]

Prior Law

In general

Under present and prior law, if the production, purchase or sale of merchandise is a material income producing factor to a taxpayer, a taxpayer is required to keep inventories and to use an accrual method of accounting with respect to the production, purchase or sale of merchandise. Acceptable methods of accounting for inventories include specific identification, first-in first-out (FIFO), last-in first-out (LIFO), and, in certain limited circumstances, average cost.

One method of applying the LIFO method to inventories is the dollar-value method. Under the dollar-value LIFO method, the taxpayer accounts for its inventories on the basis of a pool of dollars rather than on an item-by-item basis. Each pool of dollars includes the value of a number of different types of inventory items. Generally, for wholesalers, retailers, jobbers and distributors, items of inventory are pooled by major lines, types or classes of goods. In the case of manufacturers, all inventory items which represent a natural business unit may be combined into a single pool. Similarly, taxpayers may assign inventory items to one of a number of pools determined by the similarity of the different types of items to each other. A taxpayer with average annual gross receipts of no more than $2 million for its three most recent taxable years may elect to use a single pool for all items of inventory.

The dollar-value method measures each pool of dollars in terms of the equivalent dollar value of the inventories at the time the portion of the pool of dollars was first added to the inventory account. In order to measure the pool of dollars in terms of equivalent dollar values, the use of the dollar-value LIFO method requires the development of an index which will discount present dollar values back to the equivalent dollar values of the first year the taxpayers uses the LIFO method (called the "base year"). This is normally done by comparing the dollar amount of inventory items measured in present year prices against the dollar amount of the same inventory items in base year prices (the "double-extension" method). If the permission of the Secretary of the Treasury is obtained, however, the index may be developed by comparing the dollar amount of inventory items measured in present year prices against the dollar amount of the same inventory items measured in the immediate prior year's prices. This computation yields an annual index component that, when applied to all prior annual index components, creates a cumulative index which discounts present dollar values back to the equivalent dollar values of the base year (the "link-chain" method).

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[4] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 901; H. Rep. 99-426, pp. 598-604; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 290-292 (Conference Report).

Instead of using actual inventory prices, a taxpayer may use tables of price changes published by the Bureau of Labor Statistics as part of the "Producers Price Index" and "Consumer Price Index" publications to construct the index necessary to determine equivalent dollar values. Use of these tables requires an index specific to the taxpayer to be constructed by taking a weighted average of price changes for specific categories of inventory. A taxpayer with average annual gross receipts for its most recent three years of no more than $2 million may use 100% of the constructed index. Taxpayers with greater average annual gross receipts are limited to an index equal to 80% of the constructed index.

Reasons for Change

The LIFO method generally is considered to be an advantageous method of accounting for inventories, particularly when costs are rising. The LIFO method matches the costs of the most recent additions to inventories against sales. When costs are rising, a higher measure of costs of goods sold results and, consequently, a lower measure of taxable income.

The Congress believed, however, that the complexity and greater costs of compliance associated with the LIFO method, including the dollar-value LIFO method, discouraged some smaller taxpayers from using the LIFO method in accounting for their inventories. The Congress believed that the LIFO method should be simplified for smaller taxpayers so that the use of the method will be practical for all taxpayers.

Explanation of Provision

In general

The Act provides an election to certain small businesses to use a simplified dollar-value LIFO method in accounting for their inventories. The simplified dollar-value LIFO method requires inventories to be grouped into pools in accordance with the major categories of the "Producer Prices Indexes" or the "CPI Detailed Report." The change in inventory costs for the pool for the taxable year is determined by the change in the published index for the general category to which the pool relates. The computation of the ending LIFO value of the pool is then made using the dollar-value LIFO method. The indices necessary to compute the equivalent dollar values of prior years are to be developed using the link-chain method.

Eligible businesses

A taxpayer is eligible to use the simplified dollar-value LIFO method if its average annual gross receipts for its three preceding taxable years (or for such part of the previous three years that the taxpayer has been actively engaged in a trade or business) do not exceed $5 million. In the case of a taxpayer who is a member of a controlled group, all persons who are members of the controlled group are to be treated as a single taxpayer for the purpose of determining average annual gross receipts. A controlled group consists of all persons who would be treated as a single employer under sections 52 (a) or (b).

The provision of the Act is a replacement for the prior law rule allowing taxpayers with average annual gross receipts of $2 million or less to elect to use a single inventory pool in accounting for its inventories using the LIFO method (sec. 474 of prior law). Any taxpayer who has in effect a valid election to use the single pool method of section 474 of prior law may continue to account for its inventories using that election, so long as the taxpayer continues to meet the requirements for that election. A taxpayer accounting for its inventories using the single pool election of section 474 of prior law is not eligible to elect to use the simplified dollar-value LIFO method of the Act for any year in which the election under prior law is effective. Under the Act, the election to use the single pool method of section 474 of prior law may be revoked without the consent of the Secretary of the Treasury.

Making the election

A taxpayer may elect to use the simplified dollar-value LIFO method without the consent of the Secretary of the Treasury. The election is to be made at such time and in such manner as the Secretary of the Treasury may prescribe. An election to use the method applies to the year of election and to all succeeding taxable years, unless permission to change to another method is obtained from the Secretary of the Treasury, or the taxpayer becomes ineligible to use the simplified dollar-value LIFO method as a result of having exceeded $5 million of average annual gross receipts.

If the taxpayer previously has used a method of accounting for its inventories which allows the value of the inventories to be written down below cost, any amount of such writedown must be restored to income in accordance with section 472(d).

If the taxpayer makes an election to use the simplified dollar-value LIFO method, the method must be used for all the inventories of the taxpayer that are accounted for using a LIFO method.

Computation of simplified dollar-value LIFO inventories

In general.—The computation of inventory values using the simplified dollar-value LIFO method generally follows the rules provided for the computation of inventories using the dollar-value LIFO method in present Treas. Regs. sec. 1.472-8. The simplified dollar-value LIFO method differs from these current rules, however, with regard to the manner in which inventory items are to be pooled, the use of published indices to determine an annual index component for each pool, and the technique to be used in computing the cumulative index for a pool for any given year.

The simplified dollar-value LIFO method requires the use of multiple pools in order to avoid the construction of a weighted index specific to the taxpayer. Rather than construct such an index, the annual change in costs for the pool as a whole is measured by the change in the published index for the general category. The percentage change for the year in the published index for the general category determines the annual index for the pool.

The simplified dollar-value LIFO method uses the link-chain approach, rather than the double-extension approach, to compute a cumulative index for the purpose of determining equivalent dollar values in prior years.

Establishment of inventory pools.—The simplified dollar-value LIFO method requires inventory pools to be established based on either the 15 general (2 digit) categories of the "Producers Prices and Price Indexes for Commodity Groupings and Individual Items" (currently "Table 6. Producer prices and price indexes for commodity groupings and individual items, Producers Price Indexes" published monthly by the Bureau of Labor Statistics) or the 11 general categories of the "Consumer Price Index for All Urban Consumers" (currently "Table 3. Consumer Price Index for All Urban Consumers: Food expenditure categories, U.S. city average, CPI Detailer Report" and "Table 5. Consumer Price Index for All Urban Consumers: Nonfood expenditures categories, U.S. city average, CPI Detailed Report" published monthly by the Bureau of Labor Statistics) as set forth in Treas. Regs. sec. 1.472-8(e)(3)(iv).[5] Retailers using the retail method are to use the CPI categories and all other taxpayers must use the Producers Price Index categories.

Selection of index.—The taxpayer must establish a month within its taxable year and use it to measure the annual change in the index for all pools. Once the choice of month is established, another month may not be used unless advance permission to do so is granted by the Secretary of the Treasury. The annual change is measured from the established month in one calendar year to the same month in the next calendar year. Comparison of different months to measure change is not allowed. If the published index figure which the taxpayer has used to measure annual change in costs for an inventory pool is restated by the Bureau of Labor Statistics after the taxpayer has filed its return for the taxable year in question, the return may not be filed again or amended in order to reflect the restatement. Instead, the change in costs for the pool for the next taxable year will be measured with regard to the index figure which was used to measure the change in costs for the prior taxable year as the return was filed, and not the restated value.

Rules applicable to year of change.—The first year for which the simplified dollar-value LIFO method is used will represent a new base year for the purpose of the dollar-value LIFO computation. The base year dollar value of each pool will be the portion of the beginning inventory value for such first year which is attributable to the inventory items represented by such pool.

The computations necessary to convert a taxpayer's inventories to the simplified dollar-value LIFO method will depend upon the method that was used to account for the inventories prior to the year of election. A taxpayer that has been using the FIFO method to value its inventories must establish base year dollar values for each of its pools by assigning the inventory items to their respective pools and combining their values. The combined values of inventory items assigned to a pool constitute the base year layer of the pool for future dollar-value LIFO computations.

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[5] The 11 categories in the Consumer Price Index are food and beverages; housing, maintenance and repair commodities; fuels (other than gasoline); house furnishings and housekeeping supplies; apparel commodities; private transportation (including gasoline); medical care commodities; entertainment commodities; tobacco products; toilet goods and personal care appliances; and school books and supplies. The 15 categories in the Producers Price Index are farm products; processed food and feeds; textile products and apparel; hides, skin, leather, and related products; fuels and related products and power; chemicals and allied products; rubber and plastic products; lumber and wood products; pulp, paper, and allied products; metals and metal products; machinery and equipment; furniture and household durables; nonmetalic mineral products; transportation equipment; and miscellaneous products.

A taxpayer changing to the simplified dollar-value method from a method that allows inventories to be stated at less than cost (such as the FIFO method) must restore to income any amounts by which the previous inventories were written down below cost, as required by section 472(d). The base year dollar value of the pools established for dollar-value computations will include any amounts required to be recognized as income by section 472(d).

A taxpayer that has been using a LIFO method must establish values for each of its pools expressed in base year dollars in generally the same manner as does a taxpayer that has been using the FIFO method. In order to preserve pre-existing LIFO layers, however, the entire value of the inventory is not considered as attributable to the base year as is the case for taxpayers that have been using the FIFO method. Instead, the taxpayer is required to restate the prior years" layers in values expressed in base year dollars by comparing the prices at which such goods were added to inventories and determining an index for the layer with reference to the present value of the same inventory item.

Example.—The following example shows the computations required by a taxpayer in the first year in which it uses the simplified dollar-value LIFO method. The example assumes that the taxpayer used the FIFO method to calculate inventories in prior years.

The taxpayer's inventories consist of a chemical, classified in the "Chemicals and Allied Products" general category, and a high school chemistry text book, classified in the "Pulp, Paper and Allied Products" general category. The index numbers for the "Chemicals and Allied Products" general category are 200 for the prior year (the "base year") and 220 for the current year (the "first LIFO year"). The index numbers for the "Pulp, Paper and Allied Products" general category are 142 for the prior year and 150 for the current year. In the prior year, the present dollar value of the taxpayer's ending inventory was $30,000 for the chemical and $30,000 for the textbooks. In the current year, the present dollar value of the taxpayer's ending inventory is $35,000 for the chemical and $30,000 for the textbooks.

As the two types of inventory items are classified in different general categories, the taxpayer must set up a separate dollar-value LIFO pool for each. The annual index for each pool is determined by taking one plus the percentage change in the index for the general category, as shown in the following table.

Pool	Curent year index	Prior year index	Change	Percent change	Index
#1...	220	200	20	0.1000	1.1000
#2...	150	142	8	0.0563	1.0563

For years after the first year in which the method is used, the annual index would be multiplied by the cumulative index for the prior year to determine the current cumulative index. For the first year in which the simplified dollar-value LIFO method is used, the annual index and the cumulative index are the same.

The present dollar value of the ending inventory for the current year is divided by the cumulative index to restate the ending inventory in its equivalent value in base year dollars. This amount is assigned to the appropriate LIFO inventory layers and multiplied by the cumulative index for the year to which the layer relates in order to find an indexed dollar value for that layer. The sum of the indexed dollar values for the layers is the ending LIFO inventory value for the pool. These computations, for the taxpayer's first year using the simplified dollar-value LIFO method, are shown below.

POOL #1:

Current year dollar value of inventory	$35,000
Divided by index	1.100
Inventory in base year dollars	$31,818

LIFO layers	Base year dollar value	Dollar index	Indexed dollar value
Base year	$30,000	1.0000	$30,000
First LIFO year	1,818	1.1000	2,000
Ending inventory	$31,818		$32,000

POOL #2:

Current year dollar value of inventory	$30,000
Divided by index	1.0563
Inventory in base year dollars	$28,401

	Base year dollar value	Index	Indexed dollar value
Base year	$28,401	1.0000	$28,401
First LIFO year	0	0	0
Ending inventory	$28,401		$28,401

TOTAL ENDING INVENTORY:

Pool #1	$32,000
Pool #2	28,401
	$60,401

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $131 million in 1987, $207 million in 1988, $317 million in 1989, $513 million in 1990, and $807 million in 1991.

C. Installment Sales (Secs. 811 and 812 of the Act and secs. 453, 453A and 453C of the Code) [6]

Prior Law

In general

Under both present and prior law, gain or loss from a sale of property generally is recognized in the taxable year in which the property is sold. Nonetheless, gain from certain sales of property in exchange for which the seller receives deferred payments is reported on the installment method, unless the taxpayer elects otherwise (sec. 453). Eligible sales include dispositions of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan (sec. 453A) and other dispositions of noninventory property, including publicly traded property, where at least one payment is to be received after the close of the taxable year in which the disposition occurs (sec. 453(b)(1)). The installment method may not be used where a sale results in a loss.

Under the installment method, in any taxable year, a taxpayer recognizes income resulting from a disposition of property equal to an amount that bears the same ratio to the payments received in that year that the gross profit under the contract bears to the total contract price. Payments taken into account for this purpose generally include cash or other property (including foreign currency and obligations of third parties), marketable securities, certain assumptions of liabilities, and evidences of indebtedness of the purchaser that are payable on demand or are readily tradable (Temp. Treas. Reg. sec. 15A.453-1(b)(3)).

For example, assume property that has a basis of $50,000 is sold in a transaction eligible for installment reporting. The seller receives $40,000 immediately in cash and will receive $60,000 (plus interest at the current market rate) in the next taxable year. Under the installment method, the seller recognizes $20,000 of gain immediately—$50,000/$100,000 (gross profit ratio) times $40,000 (payments received). The seller recognizes the remaining $30,000 of gain when the final payment is received—$50,000/$100,000 times $60,000.

Sales under a revolving credit plan

Taxpayers who sell property under arrangements commonly known as revolving credit plans are permitted to treat a portion of the receivables arising from sales on such a plan as installment receivables and report income therefrom on the installment method (Treas. Reg. sec. 1.453-2(d)). In general, those regulations define a revolving credit plan to include a cycle budget account, a flexible budget account, a continuous budget account, and other similar arrangements under which the customer agrees to pay a part of the outstanding balance of the customer's account during each period of time for which a periodic statement of charges and credits is rendered.

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[6] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 903; H.Rep. 99-426, pp. 609-615; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 311 and 312; S.Rep. 99-313, pp. 122-132; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 293-301 (Conference Report).

Dispositions of installment obligations

Generally, if an installment obligation is disposed of, gain (or loss) is recognized equal to either (a) the difference between the amount realized and the basis of the obligation in the case of satisfaction at other than face value, or sale or exchange of the obligation, or (b) the difference between the fair market value of the obligation at the time of the disposition and the basis of the obligation in the case of any other disposition (sec. 453B). The basis of the obligation is equal to the basis of the property sold plus amounts of gain previously recognized, less the amount of any payments received. In general, under prior law, the mere pledge of an installment obligation as collateral for a loan is not treated as a disposition.[7]

Reasons for Change

Proportionate disallowance rule

In general, the underlying reason for allowing the reporting of gain on the installment method for Federal income tax purposes is that the seller may be unable to pay tax currently because no cash may be available until payments under the obligation are received. The Congress believed that the ability to defer taxation by using the installment method is inappropriate in the case of gains realized by dealers on ordinary income assets, and also with respect to gains realized on certain business or rental property, to the extent that the taxpayer has been able to receive cash from borrowings related to its installment obligations.

The Congress believed that the borrowings of a taxpayer generally are related to its installment obligations in one of two ways. In general, either the taxpayer would not undertake all or a portion of the borrowings but for its extending credit in connection with the sale of its property, or the taxpayer's borrowing ability is enhanced by the presence of the installment obligations among the taxpayer's assets. The Congress recognized, however, that it is extremely difficult to determine with any precision the extent of the nexus between the taxpayer's borrowings and its installment obligations. Hence, the Congress believed it appropriate to adopt a rule which assumes that the borrowings of the taxpayer may be allocated among the taxpayer's assets on a pro rata basis. Nevertheless, the Congress believed that personal use property, as well as indebtedness secured primarily by such property, should not be taken into account.

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[7] *See, e.g., Town and Country Food Co., Inc.* v. *Commissioner*, 51 T.C. 1049 (1969), acq. 1969-2 C.B. XXV; *United Surgical Steel Company, Inc.* v. *Commissioner*, 54 T.C. 1215 (1970), acq. 1971-2 C.B. 3.

The Congress recognized that arguments may be made that, in certain circumstances, a taxpayer's borrowings may appear to have no nexus whatsoever to its installment obligations, and that, in other circumstances, a taxpayer's borrowings may appear to be so closely related to its installment obligations that the installment obligations could appropriately be treated as having been disposed of.[8] Nevertheless, rather than making necessary the difficult and subjective inquiry regarding the nexus between the borrowings of a taxpayer and its installment obligations, the Congress believed that imposing a limitation based on a pro rata allocation of the taxpayer's borrowings is an appropriate accommodation of competing concerns.

The Congress believed, however, that it is appropriate to provide elective treatment for installment obligations arising from certain sales of real property or similar interests. These interests generally are "timeshares" and residential lots. The Congress believed that taxpayers making such sales should not be subject to the proportionate disallowance rule if they elect to pay interest to compensate the Federal Government for the the benefit of deferring the payment of their tax liability.

In addition, the Congress believed that an exception should be provided for installment obligations arising from sales by a manufacturer to a dealer, where the term of the dealer's obligation is based on the time that the dealer resells or rents the property, where the seller has the right to repurchase the property after a specified period, and where the amount of the dealer's outstanding installment obligations is a significant percentage of its total sales to dealers. The Congress believed that the taxpayer should not be required to recognize income under the proportionate disallowance rule in such circumstances because this type of arrangement sufficiently resembles a consignment arrangement of the dealer's inventory to warrant an exception from the general rule.[9]

Revolving credit plans and publicly traded property

In addition to the general limitation on the use of the installment method, the Congress believed that two additional limitations should be imposed. First, the Congress believed that sales under a revolving credit plan should not be permitted to be accounted for under the installment method. The Congress believed that such sales more closely resemble the provision of a flexible line of credit accompanied by cash sales by the seller, and therefore is not appropriately afforded the use of the installment method. Second, the Congress believed that the installment method should not be available for sales of certain publicly traded property. Since the taxpayer can easily sell such property for cash in the public market, the Congress believed that such property does not present the same liquidity problem that the installment method is intended to alleviate.

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[8] The Congress intended no change in present law regarding the circumstances under which an installment obligation may be treated as having been disposed of.

[9] The Congress intended no inference regarding the treatment of any particular transactions as either sales or consignments.

Explanation of Provision

In general

In general, the Act limits the availability of the installment method of accounting in three circumstances. First, the Act disallows the use of the installment method with respect to a portion of certain installment receivables, based on the amount of the outstanding indebtedness of the taxpayer. The Act grants an election to taxpayers selling certain "timeshares" and residential lots whereby such taxpayers may elect to pay interest on the deferral of their tax liability and not be subject to the general rules under the Act relating to installment sales. In addition, the Act retains prior law for certain installment obligations the term of which is dependent on the time of resale (or of the renting) of the property whose sale gave rise to the obligation.

Second, the Act prohibits taxpayers from using the installment method for sales pursuant to a revolving credit plan. Third, the Act provides that the installment method cannot be used for sales of certain publicly traded property.

Proportionate disallowance rule

In general

Under the Act, use of the installment method for certain sales by persons who regularly sell real or personal property described in section 1221(1), and for certain sales of business or rental property, is limited based on the amount of the outstanding indebtedness of the taxpayer. The limitation generally is applied by determining the amount of the taxpayer's "allocable installment indebtedness" for each taxable year and treating such amount as a payment immediately before the close of the taxable year on "applicable installment obligations" of the taxpayer that arose in that taxable year and are still outstanding as of the end of the year.[10]

"Allocable installment indebtedness"

Definition of "allocable installment indebtedness".—In general, allocable installment indebtedness for any taxable year is determined by (1) dividing the outstanding face amount of the taxpayer's "applicable installment obligations" held at the end of the year by the sum of (a) the outstanding face amount of all installment obligations (i.e., both applicable installment obligations and all other installment obligations)[11] and (b) the adjusted basis of all other assets of the taxpayer as of the end of the year (taking into account adjustments affecting basis for such year, including depreciation),[12] (2) multiplying the resulting quotient by the appropriate measure of the taxpayer's indebtedness, and (3) subtracting any allocable installment indebtedness that is attributable to applicable installment obligations arising in previous years. In the case of an individual, this computation does not take into account assets that are personal use property within the meaning of section 1275(b)(3) (including installment obligations arising from the sale of such property).

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[10] The provisions of the Act do not affect the treatment of any payment (within the meaning of sec. 453(c)) prior to the close of the taxable year of sale, which payment would be accounted for under the ordinary rules for applying the installment method.

[11] Thus, for example, if an installment obligation were issued with an original face amount of $1,000, and payments of $400 were actually received on the obligation during the year of sale, the outstanding face amount of the obligation for purposes of applying the provision would be $600 as of the end of the year of sale. Similarly, if an additional $400 were paid on the obligation in the subsequent year, then the outstanding face amount of the obligation would be $200 for purposes of applying the provision as of the end of such subsequent year. Payments deemed to be made under the proportionate disallowance rule do not affect the amounts treated as outstanding, however.

Definition of "applicable installment obligation".—"Applicable installment obligations" are any installment obligations that arise (1) from the sale after February 28, 1986, of personal property on the installment plan by a person who regularly sells or otherwise disposes of such personal property on the installment plan, (2) from the sale after February 28, 1986, of real property that is held by the taxpayer for sale to customers in the ordinary course of a trade or business, or (3) from the sale after August 16, 1986, of real property used in the taxpayer's trade or business or held for the production of rental income, provided that the selling price of the property exceeds $150,000, so long as the obligation in any case is held by the seller or a member of the same affiliated group as the seller.[13] Applicable installment obligations do not include, however, installment obligations arising from the sale of property used or property produced in the the trade or business of farming.[14]

The Congress also intended that the term "applicable installment obligation" include any obligation held by any person if the basis of such obligation in the hands of such person is determined (in whole or in part) by reference to the basis of such obligation in the hands of another person and such obligation was an applicable installment obligation in the hands of such other person.[15]

Treatment of subsequent payments.—In each subsequent taxable year, the taxpayer is not required to recognize gain attributable to applicable installment obligations arising in any prior year to the extent that the payments in each such subsequent year on the obligations do not exceed the amount of allocable installment indebtedness attributable to such obligations (i.e., the amount of allocable installment indebtedness that has previously been allocated to the applicable installment obligation as reduced in the manner described below). On the receipt of such payments, the allocable installment indebtedness attributable to the obligation on which the payment is received is reduced (but not below zero) by the amount of such payments. Payments on an applicable installment obligation in excess of the allocable installment indebtedness allocable to such obligation are accounted for under the ordinary rules for applying the installment method.

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[12] Taxpayers may elect to use depreciation deductions as calculated under section 312(k) for purposes of computing the adjusted basis of its assets under this formula.

[13] Thus, for example, an installment obligation arising from the sale of a parcel of undeveloped land that is held for investment only (and is not held for sale to customers, or for rental, or for use in a trade or business), would not be treated as an applicable installment obligation.

[14] Thus, for example, the proportionate disallowance rule does not apply to installment obligations arising from the sale of crops or livestock held for slaughter.

[15] A technical correction may be necessary so that the statute reflects this intention. Such a correction was included in the versions of H. Con. Res. 395 which passed the House and Senate in the 99th Congress.

Treatment of applicable installment obligations arising in prior years.—In general, allocable installment indebtedness for a particular applicable installment obligation is not adjusted after its initial computation, except to reflect the receipt of payments on the installment obligation that do not result in the recognition of any additional gain. However, in order to assure that a proportionate share of a taxpayer's indebtedness is allocated to all installment obligations, additional allocable installment indebtedness may be allocated to installment obligations arising in previous years if the amount of allocable installment indebtedness for a particular taxable year exceeds the amount of applicable installment obligations arising in that year and outstanding at year end. In this situation, the amount of such excess is first allocated to (and treated as a payment on) outstanding applicable installment obligations that arose in the preceding year (but only to the extent that the face amount outstanding exceeds the allocable installment indebtedness for such obligations), and then allocated in a similar fashion to each preceding taxable year until the full amount of the excess is allocated.

Calculation of indebtedness

Under the Act, the taxpayer must compute its indebtedness for the year in order to calculate the amount of its allocable installment indebtedness. In general, the Act provides the calculation of indebtedness is to be made, for this purpose, on a quarterly basis, and the average of the four quarters is used. However, in the case of a taxpayer who has no applicable installment obligations as of the close of the taxable year, other than applicable installment obligations arising from the sale of real property used in the taxpayer's trade or business or held for the production of rental income, then the taxpayer's allocable installment indebtedness is computed by using the taxpayer's indebtedness as of the close of the taxable year rather than the average for four quarters.[16] In either case, in making the calculation, all indebtedness of the taxpayer generally is taken account including (but not limited to) accounts payable and accrued expenses as well as other amounts more commonly considered as indebtedness, such as loans from banks, and indebtedness arising from the issuance of bonds or in connection with the purchase of property by the taxpayer.[17] An exception is made, however, for indebtedness that is secured primarily by personal use property. The Congress recognized that the extent to which indebtedness relating to accrued expenses and similar items is reflected in the computation may be diminished, for example, where a taxpayer regularly pays all of its accrued expenses and similar items at month end. However, the Congress intended that any repayments of indebtedness for the purpose of avoiding this limitation be ignored for this purpose.

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[16] The Treasury Department is given authority to issue regulations that would prevent possible avoidance of the proportionate disallowance rule where the calculation of indebtedness is made on an annual basis.

[17] Where any indebtedness of the taxpayer, or any applicable installment obligation, is subject to the rules of either section 483 or section 1274, and either such section causes a portion of the principal amount of such indebtedness or applicable installment obligation to be recharacterized as interest, then the provisions of the Act are to be applied based on the restated principal amounts.

Commonly controlled groups

Under the Act, all persons treated as a single employer under section 52(a) or section 52(b) (the "controlled group") are treated as one taxpayer for purposes of making the required computations (regardless of whether they have employees). Thus, for purposes of the Act, each member is treated as having all of the assets and liabilities of every other member. Hence, in applying the proportionate disallowance rule to the controlled group, allocable installment indebtedness is determined using the aggregate of all of the assets and all of the liabilities of the members of the controlled group. The total allocable installment indebtedness so determined then is allocated pro rata to the applicable installment obligations held by members of the controlled group (regardless of the amount of any indebtedness that any particular member of the group has outstanding), and the regular provisions of the proportionate disallowance rule then are applied.

The Congress intended that any indebtedness between members of the group generally would be disregarded (as both assets and liabilities) for this purpose. In addition, the Congress intended that the adjusted basis of any asset transferred from one member of the group to another is to be reduced, for this purpose, by the portion of the gain that has not been recognized or otherwise has been deferred as of the time of the computation, either under the consolidated return regulations (*see* Treas. Reg. sec. 1.1504-13) or because the gain on the transfer was eligible to be reported under the installment method.

Regulations

The Act provides authority under which the Treasury Department may issue regulations that disallow the use of the installment method in whole or in part for transactions in which the effect of the proportionate disallowance rule would be avoided through the use of related parties, pass-through entities, or intermediaries. The Congress intended that the meaning of related party is to be construed for these purposes in a manner consistent with carrying out the purposes of the proportionate disallowance rule. Thus, the Congress intended that the regulations may treat any corporation, partnership, or trust as related to its shareholders, partners, or beneficiaries, as the case may be, in circumstances where the proportionate disallowance rule otherwise might be avoided.

The Congress intended that these regulations may aggregate the assets of the related parties for purposes of applying the proportionate disallowance rule. For example, the Congress intended that such regulations may aggregate the assets and indebtedness of a partnership and each of its partners in determining the extent to which each such partner may report gain arising from the installment sale of partnership assets on the installment method.

In addition, the Congress intended that the regulations may treat installment obligations arising from the sale of an interest in one related party by another as applicable installment obligations to the extent that installment obligations arising from the sale of the assets of the related party the interest in which is sold would be treated as applicable installment obligations.

The Congress intended that these regulations may apply in appropriate cases to all transactions after the general effective date of the provision, but prior to the issuance of the regulations.

Example

The application of the rules of the Act may be illustrated by the following example. The example assumes that the taxpayer is a dealer in real property, uses the calendar year as its taxable year, that its operations began in 1987, and that all of the taxpayer's sales are made at a profit and are accounted for under the installment method.

Calendar year 1987.—During 1987, the taxpayer sells one property[18] for $90,000, taking back the purchaser's note for the entire purchase price.[19] No payments are received on the obligation in 1987.

The aggregate adjusted basis of the taxpayer's assets, other than the installment obligation,[20] is $310,000 as of the end of 1987. The taxpayer's average quarterly indebtedness for 1987 is $200,000.

The taxpayer's allocable installment indebtedness for 1987 would be $45,000. This amount is computed by multiplying (1) the taxpayer's average quarterly indebtedness for 1987 ($200,000) by (2) the quotient of (a) the total face amount of taxpayer's outstanding applicable installment obligations ($90,000) and (b) the sum of (i) the total face amount of the taxpayer's installment obligations ($90,000) and (ii) the adjusted basis of its other assets as of the end of 1987 ($310,000). The taxpayer would be treated as receiving a payment of $45,000 on the outstanding installment obligation as of the close of 1987.[21]

Calendar year 1988.—During 1988, the taxpayer sells another property for $110,000, taking back the purchaser's note for the entire purchase price. No payments are received in 1988 on either the 1987 or 1988 installment obligations held by the taxpayer.

The aggregate adjusted basis of the taxpayer's assets, other than the installment obligations, is $400,000 as of the end of 1988. The taxpayer's average quarterly indebtedness for 1988 is $300,000.

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[18] All sales referred to in the example are assumed to be of property that is held for sale to customers in the ordinary course of the taxpayer's trade or business. The facts of the example are intended only for purposes of illustrating the provisions of the Act limiting the use of the installment method. The Congress intended no inference regarding the circumstances under which property is properly considered to be held for sale to customers in the ordinary course of a trade or business.

[19] All installment obligations received in this example are assumed not to be payable on demand or readily tradable (within the meaning of sec. 453(f)). In addition, such installment obligations are assumed to have stated interest sufficient to avoid the recharacterization of any portion of the principal amount as interest under section 483 or section 1274. Payments referred to in the example are payments of principal on the obligations.

[20] It is assumed that none of the taxpayer's assets in the example other than its applicable installment obligations are installment obligations. If so, these assets would be taken into account at their outstanding face amount rather than their adjusted basis.

[21] Where the taxpayer has more than one applicable installment obligation outstanding as of the close of the taxable year, the amount of allocable installment indebtedness for the year would be allocated pro rata (by outstanding face amount) to the obligations, and the proportionately allocated amount would be treated as a payment on each respective outstanding obligation.

The taxpayer's allocable installment indebtedness for 1988 would be $55,000. This amount is computed by multiplying (1) the taxpayer's average quarterly indebtedness for 1988 ($300,000) by (2) the quotient of (a) the total face amount of the taxpayer's outstanding applicable installment obligations ($200,000) and (b) the sum of (i) the total face amount of the taxpayer's installment obligations ($200,000) and (ii) the adjusted basis of its other assets as of the end of 1988 ($400,000), and (3) subtracting the amount of allocable installment indebtedness allocated to applicable installment obligations that arose prior to 1988 ($45,000). The taxpayer would be treated as having received a payment of $55,000 on the installment obligation that arose in 1988, as of the close of 1988.

Calendar year 1989.—In 1989, the taxpayer sells a third property for $130,000. Also in 1989, the installment obligation that the taxpayer received in 1987 is paid in full. No payments are received on either the obligation that was received in 1988 or the one received in 1989.

The aggregate adjusted basis of the taxpayer's assets, other than its installment obligations, is $360,000 as of the end of 1989. The taxpayer's average quarterly indebtedness for 1989 is $500,000.

With respect to the $90,000 payment that was received on the installment obligation that arose in 1987, the first $45,000 of the payment would not result in the recognition of any additional gain with respect to the obligation, and would reduce the amount of allocable installment indebtedness that is treated as allocated to that obligation. The next $45,000 would be treated as an additional payment on the obligation that results in the recognition of additional gain under the installment method.

Taking into account the payment on the 1987 installment obligation, the allocable installment indebtedness allocated to taxable years before 1989, for purposes of computing allocable installment indebtedness for 1989, would be $55,000 ($45,000 of allocable installment indebtedness from 1987 plus $55,000 of allocable installment indebtedness from 1988 minus $45,000 of allocable installment indebtedness from 1987 returned in 1989).

The taxpayer's allocable installment indebtedness for 1989 would be $145,000. This amount is computed by multiplying (1) the taxpayer's average quarterly indebtedness for 1989 ($500,000) by (2) the quotient of (a) the total face amount of the taxpayer's outstanding applicable installment obligations as of the end of 1989 ($110,000 plus $130,000, or $240,000) and (b) the sum of (i) the total face amount of the taxpayer's installment obligations ($240,000) and (ii) the adjusted basis of its other assets as of the end of 1989 ($360,000), and (3) subtracting the amount of allocable installment indebtedness allocated as of the close of 1989 to applicable installment obligations that arose prior to 1989 ($55,000).

Since the taxpayer's allocable installment indebtedness for 1989 ($145,000) exceeds the amount of applicable installment obligations arising in 1989 and outstanding at the end of the year ($130,000), the taxpayer is treated as having received a payment, as of the close of 1989, of $130,000 on the installment obligation that arose in 1989, and a payment of $15,000 (i.e., the excess of $145,000 over $130,000) on the installment obligation that arose in 1988.

Special election for sales of timeshares and residential lots

The Act provides an election under which the proportionate disallowance rule would not apply to installment obligations that arise from the sale of certain types of property by a dealer to an individual, but only if the individual's obligation is not guaranteed or insured by any third person other than an individual.[22] The obligation must arise from the sale of a "timeshare," or of unimproved land if the development of such land is not done by the seller of the land or any affiliate of the seller.[23]

For these purposes, a timeshare is a right to use a specified parcel of residential real property for a period not exceeding six weeks per year. The Congress intended that where an individual or any related person owns more than one timeshare in a single parcel of residential real property, then all of the timeshares of the individual and the related parties are aggregated for purposes of determining whether the six week test is met.[24] In addition, for purposes of the provision, a timeshare may include a right to use campground sites in designated locations over ascertainable periods of time for recreational (not residential) purposes.[25]

If these conditions are met, then the seller of the property that gave rise to these obligations may elect not to have the general rules of the Act relating to installment sales apply. If the seller so elects with respect to an installment obligation, he is required to pay interest on the portion of any tax for any taxable year (determined without regard to the deduction for such interest) which is attributable to the receipt of payments on such obligation in such year (other than payments received in the year of sale). Interest is computed for the period from the date of sale to the date on which the payment is received. The interest rate used for this purpose is 100 percent of the applicable Federal rate that would apply to the installment obligation received in the sale (without regard to the three-month lookback rule of section 1274(d)(2)).

Exception for certain sales by manufacturers to dealers

The Act provides an exception for installment obligations arising from the sale of tangible personal property by the manufacturer of the property (or an affiliate of the manufacturer) to a dealer,[26] but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine month period following the sale to the dealer, and certain other conditions are met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50 percent of the total sales to dealers that give rise to such receivables (the "fifty percent test") in both the taxable year and the preceding taxable year, except that, if the taxpayer met all of the requirements for the exception in the preceding taxable year, then the taxpayer would not be treated as failing to meet the fifty percent test before the second consecutive year in which the taxpayer did not actually meet the test. For purposes of applying the fifty percent test, the aggregate face amount of the taxpayer's receivables is computed using the weighted average of the taxpayer's receivables outstanding at the end of each month during the taxpayer's taxable year. In addition, these requirements must be met by the taxpayer in its first taxable year beginning after the date of enactment of the Act (October 22, 1986). For purposes of this provision, obligations issued before the date of enactment are treated as meeting the applicable requirements if such obligations are conformed to the requirements of the provision within 60 days of the date of enactment of the Act.

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[22] The Congress intended that any Federal or private insurance relating to the payment of the individual's obligation would prevent the obligation from qualifying for the special election.

[23] The Congress intended that a parcel of land is not to be considered to have been improved or developed if it merely has been provided with the benefits of common infrastructure items such as roads and sewers.

[24] For this purpose, an individual and the individual's spouse, parents, children, and grandchildren are treated as related parties.

[25] The Congress intended no inference whether income from transactions involving such "campground timeshares" may properly be accounted for on the installment method.

[26] *I.e.*, the sale of the property must be intended to be for resale or leasing by the dealer.

Receivables that meet the conditions for the exception are not subject to the provisions of the Act relating only to limitation on the use of the installment method. The Congress intended no inference regarding the treatment of these transactions for Federal income tax purposes.

Revolving credit plans

Under the Act, taxpayers who sell property on a revolving credit plan are not permitted to account for such sales on the installment method. The Act treats such sales as installment sales with respect to which all payments are received in the year of sale. For this purpose, the Congress intended that the term "revolving credit plan" have the same meaning as that under prior law.[27]

Publicly traded property

Under the Act, taxpayers who sell stock or securities that are traded on an established securities market or, to the extent provided in Treasury regulations, property (other than stock or securities) of a kind regularly traded on an established market, are not permitted to use the installment method to account for such sales. The Act treats such sales as installment sales with respect to which all payments are received in the year of sale.

The Congress intended that, in the case of sales that are made on an established market, where cash settlement of transactions customarily occurs several business days after the date on which a trade is made, that gain or loss would be recognized for Federal income tax purposes by both cash and accrual method taxpayers on the day that the trade is executed.

The Act also provides that, under regulations to be issued by the Secretary of the Treasury (which would be effective as of the time that the provisions of the Act are effective), use of the installment method may be disallowed in whole or in part where the provisions of the Act otherwise would be avoided through use of related parties or intermediaries. In general, the Congress intended that these regulations are to be similar to those relating to the proportionate disallowance rule.

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[27] *See* Treas. Reg. sec. 1.453-2(d).

Effective Date

Proportionate disallowance rule

In general, the proportionate disallowance rule is effective for taxable years ending after December 31, 1986, with respect to sales of property after February 28, 1986. For this purpose, the Congress intended that any sales of property after February 28, 1986, but before the first taxable year of the taxpayer ending after December 31, 1986, (i.e., if the taxpayer has a calendar year as a taxable year, or has a taxable period ending between February 28, 1986, and December 31, 1986), are to be treated as arising in the taxpayer's first taxable year ending after December 31, 1986.[28]

In the case of installment obligations arising from the sale of real property in the ordinary course of the trade or business of the taxpayer, any gain attributable to allocable installment indebtedness allocated to any such installment obligations that arise (or are deemed to arise) in the first taxable year of the taxpayer ending after December 31, 1986, is taken into account ratably over the three taxable years beginning with such first taxable year; for installment obligations arising in the second taxable year of the taxpayer ending after December 31, 1986, any such gain is taken into account ratably over the two taxable years beginning with such second taxable year.

The Congress intended that the rules of the Act relating to the treatment of subsequent payments on applicable installment obligations are to be applied in this situation as if the provisions were fully effective in the first taxable year ending after December 31, 1986.

In the case of installment obligations arising from the sale of personal property in the ordinary course of the trade or business of the taxpayer, any increase in the tax liability of the taxpayer for the first taxable year of the taxpayer ending after December 31, 1986, on account of the application of the proportionate disallowance rule, is treated as being imposed ratably over the three taxable years beginning with such first taxable year; any increase in tax liability for the second taxable year of the taxpayer ending after December 31, 1986, on account of the proportionate disallowance rule (disregarding the ratable share of the increase in tax liability from the preceding taxable year), is treated as being imposed ratably over the two taxable years beginning with such second taxable year.

The Congress intended that the rules of the Act relating to the treatment of subsequent payments on applicable installment obligations are to be applied in this situation as if the provisions were fully effective in the first taxable year ending after December 31, 1986.

In the case of applicable installment obligations other than installment obligations arising from the sale of real or personal property in the ordinary course of a trade or business of the taxpayer, the proportionate disallowance rule is effective for taxable years ending after December 31, 1986, with respect to sales after August 16, 1986. The Congress intended that sales after August 16, 1986, and before the taxpayer's first taxable year ending after December 31, 1986, are to be treated as arising in the first taxable year of the taxpayer ending after December 31, 1986.[29]

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[28] A technical correction may be appropriate to reflect this intention.

The Act excludes from the definition of applicable installment obligation, installment obligations arising from the sale of units of a specified condominum project. The Act also excludes certain indebtedness of a specified taxpayer from the calculation of the taxpayer's average quarterly indebtedness. In addition, the provisions of the Act are effective for taxable years ending after December 31, 1991, with respect to a specified taxpayer that incurred substantial indebtedness in connection with a specified acquisition.

Revolving credit plans

The provisions of the Act relating to sales pursuant to a revolving credit plan are effective for taxable years beginning after December 31, 1986. Any adjustment resulting from the change in method of accounting is taken into account over a period not exceeding four years. In cases where the adjustment is taken into account over a four year period, the taxpayer would take into account 15 percent of the adjustment in the first taxable year, 25 percent in the second taxable year, and 30 percent in each of the succeeding two taxable years.[30] The Congress intended that sales made pursuant to a revolving credit plan would not be subject to the proportionate disallowance rule, prior to the time at which the provisions of the Act relating to the treatment of sales pursuant to a revolving credit plan become effective.[31]

Publicly traded property

The provisions of the Act relating to sales of publicly traded property are effective for sales of property after December 31, 1986.[32]

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1,331 million in 1987, $1,761 million in 1988, $1,418 million in 1989, $1,433 million in 1990, and $1,472 million in 1991.

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[29] A technical correction may be necessary so that the statute reflects this intention.

[30] A technical correction may be necessary so that the statute reflects this intention. Such a correction was included in the versions of H. Con. Res. 395 which passed the House and Senate in the 99th Congress.

[31] A technical correction may be necessary so that the statute reflects this intention.

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D. Capitalization Rules for Inventory, Construction, and Development Costs (Sec. 803 of the Act and new sec. 263A of the Code)[33]

Prior Law

In general

Under both present and prior law, producers of property generally may not deduct currently the costs incurred in producing the property. Rather, such costs must be capitalized and recovered through an offset to sales price if the property is produced for sale, or through depreciation or amortization if the property is produced for the taxpayer's own use in a business or investment activity. Under prior law, although substantially all direct production costs were required to be capitalized, the treatment of indirect costs varied depending on the type of property produced. For example, different rules applied depending on whether the property was fungible property held in inventory, nonfungible property held for sale to customers, or property produced under a long-term contract.

Purchasers of goods for resale were subject to more liberal rules, which required only that direct acquisition costs be inventoried.

Inventories

Under both present and prior law, taxpayers must maintain inventories[34] and generally must use the accrual method of accounting for purchases and sales for Federal income tax purposes whenever necessary to clearly determine their income (sec. 471). In general, all producers and sellers of goods must maintain inventories under methods prescribed by the Internal Revenue Service that conform to the best accounting practice in the particular trade or business and that clearly reflecting income.

Purchased goods

In the case of purchased goods, a taxpayer was required under prior law to include in inventory the invoice price of the goods less any trade or other discounts. Cash discounts approximating a fair interest rate could be deducted or not at the taxpayer's option, provided a consistent practice was followed. Transportation or other necessary charges incurred in acquiring possession of the goods then were added to this adjusted invoice price in determining the total inventory costs.[35] Thus, for example, freight-in, brokerage or franchise service fees, and handling charges incurred in connection with a purchase of goods were includible in inventory costs.[36] The courts generally held that storage and other costs incurred by the taxpayer while the goods were in its possession were not inventoriable costs, but could be deducted currently.[37]

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[33] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 905; H.Rep. 99-426, pp. 615-638; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 302; S.Rep. 99-313, pp. 133-152; ; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 302-309 (Conference Report).

[34] The purpose of maintaining inventories is to assure that the costs of producing or acquiring goods are matched with the revenues realized from their sale. Inventory accounting accomplishes this by accumulating production or acquisition costs in an inventory account as they are incurred rather than allowing an immediate deduction when incurred. When the related goods are sold, these costs are removed from the inventory account and recorded as costs of sale, which reduce taxable income for the year of the sale.

Manufactured goods

The Treasury regulations required that all direct and indirect "production costs" (costs incident to and necessary for production or manufacturing operations and processes) be included in an inventory account and not used to reduce taxable income until disposition of the goods to which they related. The determination of which direct and indirect costs constitute production costs was made in accordance with the "full absorption" method.[38] Direct production costs required to be included in an inventory account included the costs of materials forming an integral part of the product or consumed in the manufacturing process, and the costs of labor that were directly involved in fabrication of the product. Direct labor costs included not only wages and salaries of production workers and supervisors, but also such items as vacation and holiday pay, payroll taxes, and payments to supplemental unemployment benefit plans paid or incurred on behalf of employees engaged in direct labor.[39]

Under the full absorption method, indirect production costs were divided into three categories. Costs in Category 1 were required to be included in inventory costs; costs in Category 2 need not be includible in inventory costs regardless of the taxpayer's financial reporting treatment; and costs in Category 3 were required to be included in inventory costs only if they were included in inventory costs for purposes of the taxpayer's financial reports.

Category 1 costs.—Category 1 costs included:

(1) repair expenses,

(2) maintenance,

(3) utilities, such as heat, power, and light,

(4) rent,

(5) indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan,

(6) indirect materials and supplies,

(7) tools and equipment not capitalized, and

(8) costs of quality control and inspection to the extent such costs are incident to and necessary for production or manufacturing operations or processes.[40]

Category 2 costs.—Category 2 costs included:

(1) marketing expenses,

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[35] Treas. Reg. sec. 1.471-3(b).

[36] *See, e.g.*, Rev. Rul. 80-141, 1980-1 C.B. 111; *McDonald* v. *Commissioner*, 2 B.T.A. 906 (1925).

[37] *See, e.g.*, *McIntosh-Mills* v. *Commissioner*, 9 B.T.A. 301 (1927), acq. VII-1 C.B. 21.

[38] Treas. Reg. sec. 1.471-11.

[39] Treas. Reg. sec. 1.471-11(b)(2).

[40] Treas. Reg. sec. 1.471-11(c)(2)(i).

(2) advertising expenses,

(3) selling expenses,

(4) other distribution expenses,

(5) interest,

(6) research and experimental expenses, including engineering and product development expenses,

(7) losses under section 165,

(8) percentage depletion in excess of cost depletion,

(9) depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported for financial statement purposes,

(10) income taxes attributable to income received on the sale of inventory,

(11) pension contributions to the extent they represent past services costs,

(12) general and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(13) salaries paid to officers attributable to the performance of services that are incident to and necessary for the taxpayer's activities as a whole, rather than to production or manufacturing operations.[41]

Category 3 costs.—Category 3 costs included:

(1) taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) attributable to assets incident to and necessary for production or manufacturing operations,

(2) depreciation reported on financial statements and cost depletion on assets incident to and necessary for production or manufacturing operations or processes,

(3) pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor incident to and necessary for production or manufacturing operations or processes,

(4) costs attributable to rework labor, scrap, spoilage, and strikes that are incident to and necessary for production or manufacturing operations or processes,

(5) factory administrative expenses (not including any cost of selling or any return of capital),

(6) salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and

(7) insurance costs incident to and necessary for production or manufacturing operations or processes (e.g., insurance on production machinery and equipment).[42]

If a taxpayer used a method of accounting for financial reporting purposes that was not allowable for Federal income tax purposes (such as the "prime cost" method, which includes as inventory costs only direct costs), taxes, depreciation, production-related officers' salaries, and insurance costs were among the principal costs required to be taken into account in inventory. Employee benefit costs and costs attributable to strikes, rework labor, scrap, and spoilage were among the principal costs not required to have been included in inventory costs.[43]

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[41] Treas. Reg. sec. 1.471-11(c)(2)(ii).

[42] Treas. Reg. sec. 1.471-11(c)(2)(iii).

Indirect production costs required to be treated as inventory costs were allocated to goods in a taxpayer's ending inventory using a method of allocation that fairly apportioned such costs among the goods produced. The Treasury regulations authorized use of either the standard cost method or the manufacturing burden rate method. In general, the standard cost method assigned a predetermined rate (e.g., $X per direct labor hour) for each element of product cost, including direct materials and labor and fixed and variable overhead. The manufacturing burden rate method was similar to the standard cost method but assigned predetermined rates only to overhead costs.

Self-constructed property and nonfungible property produced for sale

Under present and prior law, the costs of acquiring, constructing, or improving buildings, machinery, equipment, or other assets having a useful life that extends substantially beyond the end of the taxable year are not currently deductible (sec. 263).[44] Rather, such "capital" expenditures become part of the basis of the acquired, constructed, or improved property. These costs are recoverable over the useful life of the property through depreciation or amortization deductions if the property is used in a business or investment activity and has a determinate useful life, and is therefore subject to an allowance for depreciation or amortization. Otherwise, such costs are recoverable when the property is sold or otherwise disposed of. At the time of sale or other disposition, any unrecovered basis of the asset is offset against the amount realized in computing gain or loss.

A taxpayer that constructs a building or other capital asset for its own use must capitalize all direct construction costs such as direct materials and labor. Moreover, depreciation on the taxpayer's equipment used to construct the property may not be deducted currently but must be capitalized into the basis of the self-constructed property.[45]

The proper tax treatment of many indirect expenses incurred in connection with the self-construction of property, however, was less certain under prior law. One line of cases referred to the authority of section 446(b), which requires use of an accounting method that clearly reflects income, and to the Supreme Court's holding in *Idaho Power Co.* v. *Commissioner*, in holding that vacation pay, payroll taxes, health and welfare benefits, and general overhead costs and executive salaries attributable to self-construction must be capitalized rather than deducted currently.[46] Other cases used a

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[43] Treas. Reg. sec. 1.471-11(c)(3).

[44] *See also*, Treas. Reg. secs. 1.263(a)-2(a); 1.263(a)-1(b); 1.446-1(a)(4)(ii); 1.461-1(a)(2).

[45] *Idaho Power Co.* v. *Commissioner*, 418 U.S. 1 (1974).

[46] *See, e.g., Adolph Coors Co.* v. *Commissioner*, 519 F.2d 1280 (10th Cir. 1975), cert. denied, 423 U.S. 1087 (1976) (Internal Revenue Service is justified in requiring capitalization of overhead costs of construction); *Louisville & Nashville R.R. Co.* v. *Commissioner*, 641 F.2d 735, (6th Cir.

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facts and circumstances test and ruled that such indirect costs need be capitalized only to the extent they are incremental or variable overhead costs, that is, to the extent they exceed fixed overhead or vary significantly with the level of self-construction.[47]

Under the Treasury regulations, the use of "incremental" costing for indirect costs (in lieu of full absorption costing) was expressly proscribed in the case of inventory, but no such prohibition applied for self-constructed property. In some instances, the Internal Revenue Service acknowledged the deductibility of certain indirect costs incurred during self-construction. In *Idaho Power*, for example, the Service conceded that the taxpayer was entitled to deduct payroll taxes incurred with respect to employees engaged in construction of the property.

Long-term contracts

Under prior law, special accounting rules applied to taxpayers providing goods under certain types of contracts spanning two or more taxable years. A taxpayer with income and expenses from "long-term contracts" could report under the traditional cash or accrual methods which were, subject to the restrictions previously mentioned,[48] generally available to all taxpayers. At the taxpayer's election, however, income and expenses attributable to long-term contracts could be accounted for under one of two alternative methods — the percentage of completion method or the completed contract method.

A long-term contract for this purpose was a building, installation, construction, or manufacturing contract that was not completed by the end of the taxable year in which it was entered into. A manufacturing contract qualified, however, only if it involved the manufacture of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items normally requiring more than 12 months to complete.[49]

Percentage of completion method

Under the percentage of completion method, income was recognized according to the percentage of the contract completed during each taxable year. The determination of the portion of the contract completed during the taxable year could be made by either (1) comparing the costs incurred during the year to the total estimated costs to be incurred under the contract, or (2) comparing the work performed during the year with the estimated total work to be performed.[50] All costs attributable to the long-term contract were deductible in the year in which they were incurred, although a con-

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1981), aff'g, rev'g, and remanding 66 T.C. 962 (1976) (upholding Tax Court's determination that vacation pay and health and welfare benefits were subject to capitalization, but reversing as to payroll taxes); *Variety Construction Co.* v. *Commissioner*, T.C. Memo 1962-257 (1962) (overhead costs held subject to capitalization).

[47] *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275 (1967) (incremental method and full absorption method equally permissible because taxpayer used the method for 35 years and the Internal Revenue Service had previously audited the taxpayer and did not object). *See also* I.T. 2196, IV-2 C.B. 112 (1925); *Paducah Water Co.* v. *Commissioner*, 33 F.2d 559 (D.C. Cir. 1929).

[48] For example, the cash method normally may not be used by a taxpayer required to maintain inventories.

[49] Treas. Reg. sec. 1.451-3.

[50] Treas. Reg. sec. 1.451-3(c)(2).

tractor was required to maintain inventories for materials and supplies.

Completed contract method

Under the completed contract method, the entire gross contract price was included in income in the taxable year in which the contract was finally completed and accepted. All costs properly allocable to a long-term contract were deducted in the year of completion.

Regulations adopted in 1976 provided detailed rules for the allocation of costs between contract and non-contract costs. These costing rules essentially paralleled the full absorption rules, except that under the completed contract method most Category 3 costs were required to be treated as contract costs. Thus, unless a contract was subject to the "extended period long-term contract" rules described below, the following costs were not contract costs under prior law: marketing and selling expenses (including the cost of developing bids); advertising expenses; distribution expenses; interest; general and administrative expenses attributable to the performance of services that benefited the contractor's activities as a whole (e.g., payroll, legal, and accounting expenses); research and experimental expenses under section 174; losses under section 165; percentage depletion in excess of cost depletion; depreciation and amortization on idle equipment and facilities; the excess of depreciation or amortization reported for Federal income tax purposes over that reported on financial statements; income taxes attributable to income received from long-term contracts; pension and profit-sharing contributions and other employee benefits (whether representing past or current service costs); costs attributable to strikes, rework labor, scrap, and spoilage; and salaries of officers that benefit the contractor's activities as a whole.

In the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248 (TEFRA), the Congress directed the Treasury Department to modify the rules relating to allocation of costs to long-term contracts. In the case of "extended period long-term contracts"–those not expected to be completed within 24 months from the contract commencement date—certain costs previously not treated as contract costs were to be allocated to the contracts to the extent they either directly benefited or were incurred by reason of such contracts. These costs included:

(1) bidding expenses on contracts awarded to the taxpayer;

(2) distribution expenses, such as shipping costs;

(3) general and administrative expenses properly allocable to long-term contracts under regulations prescribed by the Treasury Department;

(4) research and development expenses either directly attributable to particular long-term contracts existing when the expenses were incurred, or incurred under an agreement to perform research and development;

(5) depreciation, capital cost recovery, and amortization for equipment and facilities used in the performance of extended period long-term contracts, in excess of amounts reported for financial accounting purposes;

(6) pension and profit-sharing contributions representing current service costs, and other employee benefits;

(7) rework labor, scrap, and spoilage; and

(8) percentage depletion in excess of cost depletion.

An exception to these rules was provided for contracts for the construction of real property if the contract was expected to be completed within three years, or if the contractor's average annual gross receipts for the three taxable years preceding the year of the contract did not exceed $25 million. The Treasury regulations as adopted in 1976 continued to apply to these construction contracts and to all other long-term contracts expected to be completed within two years.

The legislative history of TEFRA expressed Congress' intention that the portion of the taxpayer's general and administrative expenses that directly benefited extended period long-term contracts were to be allocated to such contracts, even though the same type of costs also benefited other activities of the taxpayer. However, general and administrative expenses incurred in the operation of the taxpayer's general management or policy guidance functions (for example, salaries of financial officers) were currently deductible.[51]

The Treasury Department issued final regulations reflecting the TEFRA modifications and clarifications in January, 1986.[52] Under these regulations, the principal distinctions between the treatment of long-term contracts and the treatment of extended period long-term contracts involved the deductibility of depreciation (in the case of assets used in the performance of particular long-term contracts, only book depreciation was allocated to contracts in the former, whereas all such depreciation was allocated to contracts in the latter); current-service pension costs (deductible for the former but not the latter); general and administrative expenses (deductible for the former if beneficial to the taxpayer's activities as a whole, but in most instances partially allocable to the contract for the latter) and research and experimental costs (deductible for the former, but treated as contract costs for the latter if directly related to a particular contract or incurred under an agreement to perform research).[53] In addition, rework labor, scrap, and spoilage costs were allocated to the contract in the case of extended period long-term contracts, but not for other long-term contracts.

Consistent with the TEFRA legislative history, the Treasury regulations adopted an expansive view of general and administrative expenses that directly benefited extended period long-term contracts and therefore must be allocated to such long-term contracts. Examples of the types of functions the cost of which ordinarily were required to be allocated included administration of manufacturing or construction projects, personnel operations, purchasing operations, materials handling and warehousing operations, accounting and data services operations related to contract activities, data processing, security services, and legal departments providing legal services with respect to contracts. Functions for which allocation of costs ordinarily were not required include overall management and policy guidance (e.g., services by the board of directors and the chief executive, financial, legal, and accounting officers if no substantial part of their services related to a particular contract), general financial planning and management, financial accounting, tax services, public relations, and internal audit.[54]

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[51] S. Rep. 97-530, 97th Cong., 2d Sess. (1982), p. 547.

[52] Treasury Decision 8067, 51 Fed. Reg. 376 (January 6, 1986).

[53] *See* Treas. Reg. secs. 1.451-3(d)(5), (6).

Interest and taxes incurred during construction

Under prior law, interest and taxes incurred by a taxpayer during construction or improvement of real property (other than low-income housing) to be used or held for sale in a trade or business or used in an activity for profit generally were required to be capitalized and amortized over 10 years (sec. 189). The construction period commenced with the date on which construction of the building or other improvement began and ended on the date it was ready to be placed in service or held for sale.[55]

The legislative history of amendments to section 189 indicated Congress' intention that the Treasury Department issue regulations allocating interest to expenditures for real property during construction consistent with the method prescribed by Financial Accounting Standards Board Statement Number 34 (FAS 34). Under FAS 34, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided included interest costs incurred by reason of additional borrowings to finance construction, and interest costs incurred by reason of borrowings that could have been repaid with funds expended for construction.[56]

No Treasury regulations were issued under section 189 of prior law.

Reasons for Change

The Congress believed that the rules of prior law regarding the capitalization of costs incurred in producing property were deficient in two respects. First, those rules allowed costs that were in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property was sold or as it was used by the taxpayer. This treatment produced a mismatching of expenses and the related income and an unwarranted deferral of Federal income taxes. Second, different capitalization rules could apply depending on the nature of the property and its intended use. The Congress was concerned that these differences could create distortions in the allocation of economic resources and the manner in which certain economic activity was organized.

The Congress believed that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome.

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[54] Treas. Reg. sec. 1.451-3(d)(9)(vi).

[55] *See* H. Rep. No. 97-760, 97th Cong., 2d Sess. (1982) at p. 485.

[56] *Id.*

Explanation of Provisions

Overview

In general, the Act applies a single set of capitalization rules (the "uniform capitalization rules") to all costs incurred in manufacturing or constructing tangible property. Special rules apply to costs incurred in the trade or business of farming. Costs incurred in the production of timber and certain ornamental trees are exempt from the provisions. Interest costs are subject to capitalization only where the interest is allocable to construction of real property or to production of personal property that is long-lived property or requires an extended period to produce.

The uniform capitalization rules (other than the interest capitalization rule) also apply to costs incurred in purchasing and holding property for resale. However, certain small businesses acquiring property for resale are exempt from the rules, and an elective simplified method is available to other resellers.

Uniform capitalization rules

In general

Under the Act, uniform capitalization rules to be prescribed by the Treasury Department govern the inclusion in inventory or capital accounts of all costs[57] which are (1) incurred in manufacturing, construction, and other types of activities involving the production of real or tangible[58] personal property, or (2) incurred in acquiring or holding property (whether tangible or intangible) for resale. Thus, the rules apply to assets or improvements to assets constructed by a taxpayer for its own use in a trade or business or in an activity engaged in for profit and to assets, whether manufactured or purchased, to be held by a taxpayer in inventory or for sale to customers in the ordinary course of business.

The Congress intended that the uniform capitalization rules essentially follow the rules applicable to extended period long-term contracts set forth in the final Treasury regulations issued under section 451. Accordingly, taxpayers subject to the rules are required to capitalize not only direct costs but also an allocable portion of most indirect costs that benefit the assets produced or acquired for resale, including general and administrative and overhead costs and other costs described in section 1.451-3 of the Treasury regulations. The Act specifically exempts from capitalization research and experimental costs deductible under section 174, costs allowable as a deduction under sections 263(c), 616(a), or 617(a) (relating to certain development and other costs of oil and gas wells or other mineral property), costs incurred in producing property pursuant to a long-term contract,[59] and costs incurred in producing timber, including ornamental evergreen trees more than six years old at the time severed from their roots.[60] In addition, consistent with the long-term contract regulations under section 451, selling, marketing, advertising, and distribution expenses were not intended to be subject to capitalization under these rules.[61]

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[57] As described below, special rules apply to interest costs.

[58] For this purpose, tangible property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book. No inference was intended as to the nature of these properties under prior law or for other provisions of the Act.

The Congress recognized that modifications of the cost allocation methods set forth in the long-term contract regulations may be necessary or appropriate to adapt such rules to production not involving a contract, and intended the Treasury Department to have the authority to make such modifications. Under prior law, the long-term contract regulations provided a large measure of flexibility to taxpayers in allocating indirect costs to contracts insofar as they permitted any reasonable method of allocation authorized by cost accounting principles. The Congress intended that a flexible approach be adopted in the Treasury regulations under this provision. Thus, taxpayers may make allocations of costs among numerous items produced or held for resale on the basis of burden rates or other appropriate methods similar to those provided under prior law.[62] However, in determining the types and amounts of costs which are subject to allocation under these methods, taxpayers shall use the rules applicable to extended period long-term contracts. Such regulations may adopt other simplifying methods and assumptions where, in the judgment of the Secretary of the Treasury, the costs and other burdens of literal compliance may outweigh the benefits.

The uniform capitalization rules are not intended to apply to expenditures properly treated as repair costs under prior law that do not relate to the manufacture, remanufacture, or production of property. Moreover, the Congress did not intend the uniform capitalization rules to affect the valuation of inventories on a basis other than cost. Thus, the rules do not affect the valuation of inventories at market by a taxpayer using the lower of cost or market method. The rules do apply, however, to inventories valued at cost by a taxpayer using the lower of cost or market method.

The Congress did not intend that taxpayers engaged in the resale of natural gas be required under the uniform capitalization rules to allocate any portion of their overhead or other indirect costs to so-called "cushion gas." For this purpose, the term "cushion gas" refers to gas necessary to maintain operating pressures in an underground gas storage facility sufficient to meet expected peak customer demand. The Congress anticipated that the Treasury Department may issue rules or regulations under which some portion of the so-called "emergency reserve" gas in such facilities also may be exempt from allocations of indirect costs under the capitalization rules of this provision.

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[59] Long-term contracts not reported under the percentage of completion method are subject to similar capitalization rules under new section 460 of the Code. (*See* section 804 of the Act, described in E. "Long-Term Contracts, below.)

[60] The definition of timber for purposes of this exception is intended to be coextensive with the definition of timber under prior law, and nothing in the definition of timber was intended to be construed as narrowing the types of activities which constitute the growing of timber for purposes of this exclusion from the uniform capitalization rules. Thus, the production of timber remains subject to the capitalization rules applicable to timber under prior law.

[61] For this purpose, distribution expenses are intended to include only external distribution costs, that is, those costs incurred in transporting goods from the taxpayer's warehouse or retail outlet to the customer, or to the customer's agent, a common carrier, or some other intermediary. Distribution expenses do not include costs of moving inventory from a taxpayer's warehouse to its retail store or other internal transportation costs.

[62] *See* Treas. Reg. sec. 1.471-11(d) (authorizing use of the manufacturing burden rate method, the standard cost method, or any other method that fairly apportions such costs among items of inventory).

Interest expense

Under the Act, interest paid or incurred during the production period of certain types of property that is allocable to the production of the property must be capitalized.[63] Property subject to the interest capitalization requirement includes property produced by the taxpayer for use in its trade or business or in an activity for profit, but only if it (1) is real property, (2) has an estimated production period exceeding two years (one year if the cost of the property exceeds $1 million), or (3) has a class life of 20 years or more under Code section 168 as amended by the Act.[64] The production period of property for this purpose begins when construction or production is commenced and ends when the property is ready to be placed in service or is ready to be held for sale. For example, in the case of property such as tobacco, wine, or whiskey that is aged before it is sold, the production period includes the aging period. Activities such as planning or design generally do not cause the production period to begin.

The determination of whether interest is allocable to the production of property is made under rules similar to the "avoided cost" principles applicable under section 189 of prior law.[65] Under those rules, any interest expense that the taxpayer would have avoided if production expenditures had been used to repay debt of the taxpayer is treated as allocable to production of property. Accordingly, under the Act, any debt that can be specifically traced to production expenditures is first allocated to production and interest on such debt is capitalized. If production expenditures exceed the amount of the specifically traceable debt, interest on other debt of the taxpayer must be capitalized to the extent of the excess. For this purpose, the assumed interest rate is an average of the rates on the taxpayer's outstanding debt, excluding debt specifically traceable to production or construction.

The term "production expenditures" for purposes of the interest allocation rule means cumulative production costs required to be capitalized, including interest required to be capitalized as a production cost for prior periods. Where an asset is used in the production of property, interest on the entire cost of that asset must be capitalized as part of the production costs of that property whether or not the entire cost of the asset previously has been reflected in the property account.

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[63] Section 189 of prior law also required capitalization of real property taxes. Under the Act, taxes that are properly allocable to such property (for example, income taxes) are subject to capitalization (or inclusion in inventory) to the same extent as other types of costs. Capitalization of interest is not required in the case of property acquired for resale (i.e., inventory held by a dealer).

[64] Where property is constructed by another for a taxpayer under a contract, interest could be subject to capitalization by the taxpayer under the rule that treat the taxpayer as the producer of the property.

[65] The avoided cost method of determining the amount of interest allocable to production was intended to apply irrespective of whether application of such method (or a similar method) is required, authorized, or considered appropriate under financial or regulatory accounting principles applicable to the taxpayer. Thus, for example, a regulated utility company must apply the avoided cost method of determining capitalized interest even though a different method is authorized or required by Financial Accounting Standards Board Statement 34 or the regulatory authority having jurisdiction over the utility. No inference was intended that the avoided cost method was not required in such circumstances under section 189 of prior law.

The interest allocable to that cost is to be determined under the general rules for allocating debt (i.e., the "specific tracing allocation method" on debt directly allocable to the asset and the "avoided cost allocation method" on other debt).[66] Where an asset is used for other purposes in addition to the production of property, only an allocable portion of the allocable interest costs must be capitalized as part of the production costs of the property.

In the case of partnerships or other flow-through entities, the allocation rules are applied first at the entity level and then (to the extent the entity has insufficient debt to support the full amount of the production expenditures) at the partner or beneficiary level.[67]

The Treasury Department is authorized to issue regulations to prevent the avoidance of these rules through the use of related parties, pass-through entities, or intermediaries. For example, such regulations could provide that where a subsidiary corporation is owned by two 50-percent parent corporations, and the subsidiary is engaged in constructing long-lived property for its own use, but has no outstanding debt, each 50-percent parent is required to capitalize interest expense as if each had directly incurred one-half of the construction expenditures incurred by the subsidiary.

If a taxpayer has property produced for it by another under a contract, the taxpayer is treated as producing the property for purposes of the uniform capitalization rules, including the interest capitalization rule. Thus, the portion of the taxpayer's interest expense allocable to costs required to be capitalized (including progress payments, advances to the contractor, and an allocable portion of the general and administrative expenses of the taxpayer) must be charged to a capital account.[68]

The Act exempts from the interest capitalization rule interest that is qualified residence interest within the meaning of section 163(h), as amended by the Act.

Pension costs

Under the uniform capitalization rules, contributions to a pension, profit-sharing, or stock bonus plan and other employee benefit expenses are considered indirect costs that must be capitalized to the same extent as other indirect costs, unless such contributions relate to past-service costs. It was intended that, in the case of a contribution to a qualified plan, the determination of whether the contribution relates to past or current services will be made independently of any allocation between "normal cost" and "past-service cost" required under the minimum funding standards (sec. 412) or under the plan's benefit formula. The Congress anticipated that the Treasury Department will publish guidelines for making this determination, and that such determination may be based, in whole or in part, on any actuarial funding methods that may be utilized by qualified defined benefit plans.

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[66] A technical correction may be necessary to reflect this intention.

[67] Interest of the partner (beneficiary) that must be capitalized under this rule may be recovered by the partner (beneficiary), under regulations issued by the Secretary of the Treasury, at the same time and to the same extent as if the interest had been paid or incurred directly by the partnership.

[68] The contractor in such circumstances is required to capitalize interest only with respect to the excess of its accumulated contract costs over the accumulated payments received during the year.

Any allocation of employee benefit costs (and any other costs) between production (or inventory, in the case of purchased goods) costs and period costs will be made after application of any other relevant limitations provided in the Code. For example, in the case of a qualified defined benefit pension plan that is subject to the minimum funding standard, an employer will first calculate his liability under the minimum funding standards (using the applicable funding method and actuarial assumptions); next, calculate the limit on deductions for such contributions (pursuant to section 404 of the Code); and finally, allocate the otherwise deductible amount between production costs and other costs applying the uniform capitalization rules. In applying these rules, the allocation of the otherwise deductible amount between past- and current-service costs will be made independently of the allocation made in the first step of the calculation, under rules published by the Treasury Department.

Similarly, in the case of a plan that is not subject to the minimum funding standards (e.g., a profit-sharing plan), an employer must compute the otherwise allowable deduction limit pursuant to section 404 and then allocate that amount between production or inventory costs and other costs.

Special rules for farmers and ranchers

Capitalization rules generally

Under the Act, the uniform capitalization rules, including those requiring capitalization of interest, generally apply to crops and livestock produced by the farmer-taxpayer having a preproductive period of more than two years. Nonetheless, except for persons or entities required to use an accrual method of accounting under section 447 or 448, the uniform capitalization rules do not apply to animals held for slaughter. For this purpose, the preproductive period of plants is deemed to begin when the plant or seed is first planted or acquired by the taxpayer, and to end when the plant produces a marketable crop (if there will be more than one yield) or is sold (if there will be a single yield). The preproductive period of animals begins at the time of acquisition, breeding, or embryo implantation. In the case of an animal that will have more than one yield, the preproductive period ends when the animal has its first yield. In the case of an animal that has a single yield, the preproductive period ends at the time of disposition. Thus, for example, the preproductive period of a cow to be used for breeding or dairy purposes would begin when that cow is conceived and end when it drops its first calf.

The preproductive period of a plant grown in the United States is determined on the basis of the national average preproductive period for the particular crop. It is expected that the Treasury Department periodically will publish a list of the preproductive periods of various plants based on a weighted average for products produced in the United States in commercial quantities.[69]

The Act directs the Treasury Department by regulations to permit the taxpayer to use reasonable inventory valuation methods to compute the amount of costs required to be capitalized in the case of a plant or animal. The Congress intended that taxpayers may determine the costs required to be capitalized by using methods similar to one of the simplified inventory valuation rules of present law (e.g., the farm-price or unit-livestock-price method) in lieu of capitalizing actual costs.

Persons or entities required to use an accrual method of accounting under sections 447 or 448 are required to capitalize preproductive period costs without regard to whether the preproductive period is more than two years. Consistent with the generally applicable uniform capitalization rules, such taxpayers are required to capitalize taxes and, to the extent the preproductive period exceeds two years, interest incurred prior to production. The Congress intended that sugar growers properly using the annual accrual method of accounting under section 447(g) will be allowed to continue to use that method.

The special rule of prior law permitting expensing of amounts incurred in replanting a grove, orchard, or vineyard after loss or damage due to freezing temperatures, disease, drought, pests, or casualty (sec. 278(c)) is modified. Under the Act, such expensing is allowed only in the case of plants that produce an edible crop for human consumption of the same type as the lost or damaged crop. For purposes of this provision, crops are edible if they are normally eaten or drunk by humans. Thus, for example, jojoba beans production does not qualify for treatment under this special rule. In addition, the provision allows expenditures in connection with replanting or maintaining a field other than the field in which the damage occurred to qualify for expensing, provided the acreage of the new field does not exceed that of the field to which the damage occurred and the new field is located in the United States.

Further, the Act expands this relief provision to include otherwise eligible costs that are incurred by persons other than the person who suffered the loss, provided two conditions are met. First, the taxpayer who owned the property at the time of the loss or damage must have an equity interest of more than 50 percent in the property. Second, the additional persons incurring the costs must hold part of the remaining equity interest in the property and must materially participate in the planting, cultivation, maintenance, or development activities that give rise to the costs. The determination of whether an individual materially participates in an activity is made under section 2032A(e)(6) (relating to current use valuation of farm property).[70]

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[69] The Treasury Department may make reasonable distinctions among different varieties of plants, and may weight the average using such factors as it deems appropriate.

[70] It is anticipated that a technical correction will be made clarifying that relief is not limited to expenses incurred by the minority participants during the four-year period beginning with the taxable year in which the loss or damage occurred; rather, the relief applies to all expenses of such taxpayers that would otherwise be subject to capitalization.

Election to deduct preproductive period expenses

The Act provides an exception to the rules requiring capitalization of preproductive period expenses for certain taxpayers engaged in a farming business. Such taxpayers may elect to deduct currently all preproductive costs of plants and animals that may be deducted under prior law. If the election is made, gain from disposition of the product is recaptured (that is, taxed as ordinary income) to the extent of prior deductions that otherwise would have been required to be capitalized. In addition, the electing taxpayer must use the alternative depreciation system for all farm assets used in any farming business placed in service in taxable years for which the election is in effect.[71]

For this purpose, the term "farming business" includes, in addition to the production of agricultural crops, the operation of a nursery or sod farm and the raising or harvesting of trees bearing fruit, nuts, or other crops, ornamental trees (other than those having a growing period in excess of six years, which are exempt from the capitalization rules), as well as agricultural crops. Taxpayers engaged in a farming business that are required to use the accrual method of accounting under section 447 or 448 and producers of pistachio nuts are not eligible to elect to be excluded from the uniform capitalization rules.

The election to deduct preproductive period costs currently does not apply with respect to any item of cost which is attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove which is incurred before the close of the fourth taxable year beginning with the taxable year in which the grove was planted.[72] If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting. In addition, the election to deduct preproductive period costs does not apply to tax shelters (as defined in section 6161(b)(2)(C)(ii)) or farming syndicates (as defined in section 464(c)).

The election to deduct preproductive period costs is irrevocable and may not be revoked except with the consent of the Commissioner of Internal Revenue. In the case of a partnership or S corporation, the election must be made at the partner or shareholder level. The election may be made only for the first taxable year that begins after December 31, 1986, and during which the taxpayer is engaged in the farming business.

The Congress intended that taxpayers making the election be allowed to estimate the amount of preproductive period expenses subject to recapture using methods similar to one of the simplified inventory methods permitted to accrual method farmers under present law.

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[71] An election by a person related to the taxpayer also binds the taxpayer to use the alternative depreciation system. For this purpose, a related person includes the spouse and all minor children of the taxpayer and on any entity in which the taxpayer owns a 50 percent or more interest (applying the attribution rules of section 318(a)).

[72] Thus, the election does not apply to the same persons who were subject to section 278 of prior law.

Special rules for retailers and wholesalers

In general, the uniform capitalization rules apply to taxpayers who acquire property for resale in the same manner as they apply to producers. However, the Act provides an exception for resellers whose average annual gross receipts[73] do not exceed $10 million, who are subject to prior-law inventory rules.

Examples of the types of costs resellers are required to treat as inventory costs are the following: costs incident to purchasing inventory (e.g., wages or salaries of employees responsible for purchasing); repackaging, assembly, and other costs incurred in processing goods; costs of storing goods (e.g., rent or depreciation, insurance premiums, and taxes attributable to a warehouse, and wages of warehouse personnel);[74] and the portion of general and administrative costs allocable to these functions.[75]

The Congress intended that, in the case of a taxpayer engaged in a retail sales business, however, only off-site storage costs—that is, costs of storing goods in a facility distinct from the facility in which the taxpayer conducts retail sales of these goods—must be treated as inventoriable costs under this provision.

Elective simplified method for allocating indirect costs

The Act directs the Treasury Department to provide a simplified method for applying the uniform capitalization rules in the case of taxpayers acquiring property for resale.

The simplified method is to be applied separately to each trade or business of the taxpayer. Taxpayers not electing to use the simplified method must apply the uniform capitalization rules to property acquired for resale under the same procedures and methods applicable to manufacturers. The Treasury Department may modify the simplified method or permit the use of other methods by rules or regulations. Once a taxpayer has chosen either the simplified method or the capitalization methods applicable to manufacturers, the taxpayer may not change its method without obtaining the permission of the Commissioner of Internal Revenue.

In applying the simplified method, taxpayers first must calculate their inventory balances without regard to the uniform capitalization rules. Then the amounts of additional costs required to be capitalized under the new rules (under the procedures described below) must be determined, and such amounts, together with the amounts of additional costs contained in beginning inventory balances where appropriate, added to the preliminary inventory balances to determine their final balances. Thus, a taxpayer using the last-in, first-out (LIFO) method makes the calculation of a particular year's LIFO index without regard to the uniform capitalization rules.

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[73] The test is applied for the three-taxable year period ending with the taxable year preceeding the year in question.

[74] The Congress intended that storage costs incurred by a manufacturer following completion or substantial completion of the manufacturing process with regard to a product (as well as those incurred during the manufacturing process) will likewise be subject to capitalization under these rules. Thus, the Act overrules any case law holding to the contrary (without inference as to the validity of such cases under prior law). *See, e.g., Heaven Hill Distilleries, Inc.* v. *U.S.*, 476 F.2d 1327 (Ct.Cl. 1973) (holding that storage costs incurred by the manufacturer of whisky during the aging process were currently deductible), and *Van Pickerill & Sons, Inc.* v. *U.S.*, 445 F.2d 918 (7th Cir. 1971).

[75] No inference is intended regarding the deductibility of such costs under prior law.

However, costs capitalized under these rules are added to the LIFO layers applicable to the various years for which the costs were accumulated. Likewise, in the case of a taxpayer on the first-in, first-out (FIFO) method that does not sell its entire beginning inventory during the year, a proportionate part of the additional costs capitalized into the beginning inventory under these rules is included in ending inventory.

In general, four categories of indirect costs are allocable to inventory under the simplified method:

(1) off-site storage and warehousing costs (including, but not limited to, rent or depreciation attributable to a warehouse, property taxes, insurance premiums, security costs, and other costs directly identifiable with the storage facility);[76]

(2) purchasing costs such as buyers' wages or salaries;

(3) handling, processing, assembly, repackaging, and similar costs, including labor costs attributable to unloading goods (but not including labor costs attributable to loading of goods for final shipment to customers, or labor at a retail facility);[77] and

(4) the portion of general and administrative costs allocable to these functions.

Effective Dates

Inventories

In general

The uniform capitalization rules apply to inventories for the taxpayer's first taxable year beginning after December 31, 1986. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481. Taxpayers must spread the section 481 adjustment over a period not exceeding four years, in accordance with the rules applicable to a change in method of accounting initiated by the taxpayer and approved by the Internal Revenue Service. Accordingly, taxpayers must revalue inventory on hand as of the effective date to reflect the greater absorption of production costs under the new rules. Normally, the revaluation must be done by valuing the items included in inventory on the effective date as if the new absorption rules had been in effect during all prior periods. The difference between the inventory as originally valued and the inventory as revalued will be the amount of adjustment required by section 481.

However, the Congress recognized that, in some circumstances, particularly where the taxpayer is considered as holding in inventory items which were acquired for resale, produced, or manufactured a number of years prior to the effective date of the Act, the information necessary to calculate the section 481 adjustment using the precise method may not be available. Such a situation may arise, for example, if the taxpayer has items of inventory that it no longer produces, or if the taxpayer is using the LIFO method of accounting. The Congress expected that the Treasury Department will issue regulations or rulings permitting a taxpayer in this situation to estimate the amount by which the inventory must be revalued by using available data, as illustrated by the examples below.

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[76] Off-site storage and warehousing costs generally include the costs of a facility which function in the storage or warehousing of goods.

[77] Any reasonable method of apportioning labor costs between inventoriable and noninventoriable functions may be used. The Congress did not intend that detailed records establishing the time spent by an employee performing a particular function generally will be required to substantiate an allocation by the taxpayer. However, if such records are available, they generally should be used in making allocations.

The Congress intended that net operating loss and tax-credit carryforwards will be allowed to offset any positive section 481 adjustment and that, for purposes of determining estimated tax payments, the section 481 adjustment will be recognized ratably throughout the taxable year of the adjustment.

FIFO method

The computation of the section 481 adjustment for a taxpayer using the FIFO method of accounting for inventories can be illustrated as follows: Assume that the taxpayer maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1984, for which year the taxpayer determines a revaluation of inventory costs resulting in a 20 percent increase. A portion of the inventory of bolt A, however, is attributable to 1983 for which the taxpayer does not have sufficient data for revaluation. Bolt B was last produced in 1982 and no data exists which would allow revaluation of the inventory cost of bolt B pursuant to the new absorption rules. The inventories of all bolts other than bolts A and B are attributable to 1984 and 1985 production, for which revaluation using available data results in an average 15 percent increase in inventory cost. With respect to bolt A, the 20 percent increase determined for 1984 also may be applied to the 1983 production as an acceptable estimate. With respect to bolt B, the overall 15 percent increase for the inventory as a whole may be used in valuing the costs of bolt B.

LIFO method

Taxpayers using the LIFO method of valuing inventories also may have difficulty in assembling sufficient data to restate their inventory costs. Taxpayers using the dollar-value LIFO method may have particular problems since the valuation of each year's LIFO layer is dependent upon prior year's cost data in situations where the double extension method is used.

The Congress expected that taxpayers using the specific goods LIFO method to value their inventories generally will be allowed to use the same type of estimating techniques as FIFO taxpayers. Thus, the percentage change obtained in revaluing those inventory layers for which sufficient data is available may be applied to revalue all preceding years' layers.

Example 1.—For example, assume a manufacturer produces two different parts. Work-in-process inventory is recorded in terms of equivalent units of finished goods. The manufacturer's specific goods LIFO inventory records show the following at the end of 1986:

Product and layer	Number	Cost	LIFO carrying values
Product #1:			
1983	150	$5.00	$750
1984	100	6.00	600
1985	100	6.50	650
1986	50	7.00	350
			$2,350
Product #2:			
1983	200	4.00	$800
1984	200	4.50	900
1985	100	5.00	500
1986	100	6.00	600
			$2,800
Total of carrying value of Products #1 and #2			$5,150

Data available to the taxpayer allows it to revalue the unit costs of product #1 under the uniform capitalization rules to $7.00 in 1984, $7.75 in 1985 and $9.00 in 1986, and to revalue the unit costs of product #2 to $6.00 in 1985 and $7.00 in 1986. The available data for product #1 results in a weighted average percentage change for product #1 of 20.31 percent.[78] The available data for product #2 results in a weighted average percentage change for product #2 of 18.18 percent.[79]

The weighted average increase estimation does not affect the revaluation of costs for those years in which actual revaluation is possible. The revalued inventory of the taxpayer would be as follows:

Product and layer	Number	Cost	LIFO carrying values
Product #1:			
1983	150	$6.02	$903
1984	100	7.00	700
1985	100	7.75	775
1986	50	9.00	450
			$2,828

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[78] This is computed as follows: [(100 X ($7.00 - $6.00)) + (100 X ($7.75 - $6.50)) + [50 X ($9.00 - $7.00)] divided by [(100 X $6.00) + (100 X $6.50) + (50 X $7.00)].

[79] This is computed as follows: [(100 X ($6.00 - $5.00)) + (100 X ($7.00 - $6.00))] divided by [(100 X $5.00) + (100 X $6.00)].

Product and layer	Number	Cost	LIFO carrying values
Product #2:			
1983	200	4.73	$946
1984	200	5.32	1,064
1985	100	6.00	600
1986	100	7.00	700
			$3,310
Total of carrying value of Products #1 and #2 under new absorption rules			$6,138

A taxpayer using the specific goods LIFO method also may have inventories for which new costs have not been incurred for several years and, consequently, a weighted average increase for those particular inventory items may not be available for estimation purposes. In such a case, the taxpayer may take the weighted average increases for all its revalued inventory items and determine an overall percentage increase, weighted by the value of each inventory item included in the calculation, to estimate the revaluation necessary for such items.

The Congress anticipated that the Treasury Department will develop rules to permit taxpayers using the dollar-value LIFO method who lack sufficient data to revalue all of their LIFO layers under the uniform capitalization rules to compute the percentage change in the current costs of their inventory as a result of the rules for the LIFO layers accumulated during the three most recent years that the taxpayer has sufficient information. (These rules will apply to taxpayers acquiring property for resale, as well as taxpayers producing or manufacturing property.) Taxpayers then will apply that percentage to restate the costs of the beginning LIFO inventory value of the entire pool for the year of change. For purposes of determining future indexes, the year prior to the year of change will then be considered as a new base year and the current costs for that year are to be used for extension purposes to future taxable years. The increase in the beginning balance in the LIFO inventory as a result of this change will represent the section 481 adjustment amount.

Example 2.—For example, assume a calendar year taxpayer first adopted the dollar value LIFO method in 1981, using a single pool and the double extension method. The taxpayer's beginning LIFO inventory for the year of change is as follows:

	Base year costs	Index	LIFO carrying value
Base layer	$14,000	1.00	$14,000
1981 layer	4,000	1.20	4,800
1982 layer	5,000	1.30	6,500
1983 layer	2,000	1.35	2,700
1984 layer	0	1.40	0
1985 layer	4,000	1.50	6,000
1986 layer	5,000	1.60	8,000
Total	$34,000		$42,000

The taxpayer is able to recompute inventoriable cost under the new absorption rules for the ending LIFO layers for three preceding taxable years as follows:

Year	Current cost as recorded	Current cost as adjusted	Weighted percentage change
1984	$35,000	$45,150	0.29
1985	43,500	54,375	.25
1986	54,400	70,720	.30
Total	$132,900	$170,245	.28

Applying the average revaluation factor of .28 to each layer, the inventory is restated as follows:

	Base year costs	Index	LIFO carrying value
Base layer	$17,920	1.00	$17,920
1981 layer	5,120	1.20	6,144
1982 layer	6,400	1.30	8,320
1983 layer	2,560	1.35	3,456
1984 layer	0	1.40	0
1985 layer	5,120	1.50	7,680
1986 layer	6,400	1.60	10,240
Total	$43,520		$53,760

The section 481 adjustment is the difference between the revalued LIFO carrying value under the new absorption rules and the LIFO carrying value as originally reported. In this example, the section 481 adjustment is $11,760 ($53,760 −$42,000). The section 481 adjustment also may be found by multiplying the LIFO carrying value as originally reported by the average percentage change determined in the first step described above. In this example, that procedure also would determine the amount of the section 481 to be $11,760 ($42,000 × .28).

The year prior to the year of change will be treated as a new base year for the purpose of determining the index in future years. This requires that layers in years prior to the base year be restated in terms of the new base year index. In the example above, the restated inventory would be as follows:

	Restated base year costs	Index	LIFO carrying value
Old base layer	$28,672	0.625	$17,920
1981 layer	8,192	.75	6,144
1982 layer	10,234	.813	8,320
1983 layer	4,095	.844	3,456
1984 layer	0	.875	0
1985 layer	8,188	.938	7,680
New base layer (1986)	10,240	1.00	10,240
Total	$69,621	....	$53,760

For taxpayers not possessing sufficient data to revalue all of their LIFO layers under the new absorption rules, the most recent three years prior to the year of change for which the taxpayer has sufficient information may be used in determining the average revaluation factor. Where the taxpayer possesses sufficient information to use additional years in determining the average revaluation factor, such additional years may be used at the option of the taxpayer, as long as the additional years are consecutive years prior to the year of change. For example, assume a calendar year taxpayer has sufficient information to revalue years 1981 through 1986. The average revaluation factor may be determined on the basis of all six years. On the other hand, a taxpayer with sufficient information to revalue 1980 through 1982 and 1984 through 1986 would use only the 1984 through 1986 years in determining the average revaluation factor, since the years 1980 through 1983 are not consecutive to the year of change.

The use of the average revaluation factor based upon current costs to estimate the revaluation of older inventory layers may result in an increase in the value of inventories representing costs which did not exist in the affected year. To the extent that a taxpayer can show that costs which contributed to the determination of the average revaluation factor could not have affected a prior year, the average revaluation factor as applied to that year may be adjusted by an appropriate amount.

Self-constructed and noninventory property produced for sale

In the case of self-constructed property, the uniform capitalization rules apply to costs incurred after December 31, 1986, unless incurred with respect to property on which substantial construction occurred before March 1, 1986. The Congress intended that construction of an asset which began after February 28, 1986, will be considered within this transitional rule if the asset is an integral part of an integrated facility with respect to which substantial construction occurred before March 1, 1986. An asset generally will be considered an integral part of a facility only if such asset will be placed in service at essentially the same time as other assets comprising the facility.

In the case of noninventory property produced for sale, the rules are effective for costs paid or incurred after December 31, 1986. No restatement of beginning balances and no section 481 adjustment is required.[80]

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $4,354 million in 1987, $7,674 million in 1988, $8,185 million in 1989, $8,556 million in 1990, and $6,775 million in 1991.

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[80] *See, e.g., W.C. & A.N. Miller Development* v. *Commissioner*, 81 T.C. 619 (1983).

E. Long-term Contracts (Sec. 804 of the Act and new sec. 460 of the Code) [81]

Prior Law

In general

Under prior law, special accounting rules applied to taxpayers providing goods under certain types of contracts spanning two or more taxable years. A taxpayer with income and expenses from "long-term contracts" could report under the traditional cash or accrual methods which were, subject to the restrictions previously mentioned,[82] generally available to all taxpayers. At the taxpayer's election, however, income and expenses attributable to long-term contracts could be accounted for under one of two alternative methods—the percentage of completion method or the completed contract method.

Under prior and present law, a long-term contract is defined as a building, installation, construction, or manufacturing contract that is not completed by the end of the taxable year in which it is entered into. A manufacturing contract is within the definition, however, only if it involves the manufacture of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items normally requiring more than 12 months to complete.

Percentage of completion method

Under the percentage of completion method of prior law, income was recognized according to the percentage of the contract completed during each taxable year. The determination of the portion of the contract completed during the taxable year could be made either by (1) comparing the costs incurred during the year to the total estimated costs to be incurred under the contract, or (2) comparing the work performed during the year with the estimated total work to be performed.[83] All costs attributable to the long-term contract were deductible in the year in which they were incurred, although a contractor was required to maintain inventories for materials and supplies.

Completed contract method

Under the completed contract method of prior law, the entire gross contract price was included in income in the taxable year in which the contract was finally completed and accepted. All costs properly allocable to a long-term contract were deducted in the year of completion.

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[81] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 904; H.Rep. 99-426, pp. 615-638; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 301; S.Rep. 99-313, pp. 133-152; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 310-313 (Conference Report).

[82] For example, the cash method normally may not be used by a taxpayer required to maintain inventories.

[83] Treas. Reg. sec. 1.451-3(c)(2).

Regulations adopted in 1976 provided detailed rules for the allocation of costs between contract and non-contract costs. These costing rules essentially paralleled the full absorption rules applicable to manufacturers of inventory,[84] except that, under the completed contract method, most Category 3 (financial conformity) costs had to be treated as contract costs. Thus, unless a contract was subject to the "extended period long-term contract" rules described below, the following costs were not contract costs: marketing and selling expenses (including the cost of developing bids); advertising expenses; distribution expenses; interest; general and administrative expenses attributable to the performance of services that benefit the contractor's activities as a whole (e.g., payroll, legal, and accounting expenses); research and experimental expenses under section 174; losses under section 165; percentage depletion in excess of cost depletion; depreciation and amortization on idle equipment and facilities; the excess of depreciation or amortization reported for tax purposes over that reported on financial statements; income taxes attributable to income received from long-term contracts; pension and profit-sharing contributions and other employee benefits (whether representing past or current service costs); costs attributable to strikes, rework labor, scrap, and spoilage; and salaries of officers that benefit the contractor's activities as a whole.

In the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248 (TEFRA), the Congress directed the Treasury Department to modify the rules relating to allocation of costs to long-term contracts. In the case of "extended period" long-term contracts—those not expected to be completed within 24 months from the contract commencement date—certain costs previously not treated as contract costs were to be allocated to the contracts to the extent they either directly benefited or were incurred by reason of such contracts. These costs included:

(1) bidding expenses on contracts awarded to the taxpayer;

(2) distribution expenses, such as shipping costs;

(3) general and administrative expenses properly allocable to long-term contracts under regulations prescribed by the Treasury Department;

(4) research and development expenses either directly attributable to particular long-term contracts existing when the expenses were incurred, or incurred under an agreement to perform research and development;

(5) depreciation, capital cost recovery, and amortization for equipment and facilities used in the performance of extended period long-term contracts, in excess of amounts reported for financial accounting purposes;

(6) pension and profit-sharing contributions representing current service costs, and other employee benefits;

(7) rework labor, scrap, and spoilage; and

(8) percentage depletion in excess of cost depletion.

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[84] Treas. Reg. sec. 1.471-11. (For a discussion of these rules, see Title VIII., Part C, *supra*.)

An exception to these rules was provided for contracts for the construction of real property if the contract was expected to be completed within three years, or if the contractor's average annual gross receipts for the three taxable years preceding the year of the contract did not exceed $25 million. The regulations as adopted in 1976 continued to apply to these construction contracts and to all other long-term contracts expected to be completed within two years.

The legislative history of TEFRA expressed Congress' intention that the portion of the taxpayer's general and administrative expenses that directly benefited extended period long-term contracts must be allocated to such contracts, even though the same type of costs also benefited other activities of the taxpayer. However, general and administrative expenses incurred in the operation of the taxpayer's general management or policy guidance functions (for example, salaries of financial officers) were to remain currently deductible.[85]

The Treasury Department issued final regulations reflecting the TEFRA modifications and clarifications in January, 1986.[86] Under the regulations, the principal distinctions between the treatment of long-term contracts and the treatment of extended period long-term contracts involved the deductibility of depreciation (in the case of assets used in the performance of particular long-term contracts, only book depreciation was allocated to contracts in the former, whereas all such depreciation was allocated to contracts in the latter); current-service pension costs (deductible for the former but not the latter); general and administrative expenses (deductible for the former if beneficial to the taxpayer's activities as a whole, but in most instances partially allocable to the contract for the latter); and research and experimental costs (deductible for the former, but treated as contract costs for the latter if directly related to a particular contract or incurred under an agreement to perform research).[87]

In addition, rework labor, scrap, and spoilage costs were allocated to the contract in the case of extended period long-term contracts, but not for other long-term contracts.

Consistent with the TEFRA legislative history, the regulations adopted an expansive view of general and administrative expenses that directly benefited extended period long-term contracts and therefore had to be allocated to such long-term contracts. Examples of the types of functions the cost of which ordinarily were required to be allocated included administration of manufacturing or construction projects, personnel operations, purchasing operations, materials handling and warehousing operations, accounting and data services operations related to contract activities, data processing, security services, and legal departments providing legal services with respect to contracts. Functions for which allocation of costs ordinarily were not required include overall management and policy guidance (e.g., services by the board of directors and the chief executive, financial, legal, and accounting officers if no substantial part of their services related to a particular contract), general financial planning and management, financial accounting, tax services, public relations, and internal audit.[88]

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[85] S. Rep. 97-530, 97th Cong., 2d Sess. (1982), p. 547.

[86] Treasury Decision 8067, 51 Fed. Reg. 376 (January 6, 1986).

[87] *See* Treas. Reg. sec. 1.451-3(d)(5), (6).

Reasons for Change

The Congress believed that the completed contract method of accounting for long-term contracts permitted an unwarranted deferral of the income from those contracts. The Congress noted that the Study of 1983 Effective Tax Rates on Selected Large U.S. Corporations by the Joint Committee on Taxation indicated that some corporations had large deferred taxes and low effective tax rates as a result of their use of the completed contract method for tax purposes. Annual reports for certain large defense contractors reflected negative tax rates due to net operating loss carryforwards generated through use of the completed contract method in prior years.

The Congress believed it was appropriate to limit the tax deferral obtainable through use of the completed contract method by requiring that a portion of the income from long-term contracts be reported on a percentage of completion method. However, the Congress recognized that use of the percentage of completion method may produce harsh results for taxpayers in some cases, for example, where an overall loss is experienced on the contract, or where actual profits are significantly less than projected. The method was also subject to manipulation by taxpayers. In order to address these deficiencies in the percentage of completion method under prior law, the Congress adopted a modified version of the method, applicable whether the taxpayer uses the percentage of completion method for all or only a portion of a long-term contract. Under this modified percentage of completion method, variances between the estimated and the actual completion during each year of the contract are accounted for at the end of the contract through an interest charge or credit to the taxpayer.

The Congress also believed that, with respect to the portion of a long-term contract reported under the completed contract method (or an inventory method of accounting), income would be more clearly reflected if certain costs reimbursed under a contract, but not treated as contract costs under prior law, were subject to capitalization.

Finally, the Congress believed it was desirable to resolve (retroactively as well as prospectively) a controversy between taxpayers and the Internal Revenue Service concerning the treatment of independent research and development costs.

Explanation of Provisions

In general

Under the Act, taxpayers engaged in long-term contracts must compute income from such contracts under one of two methods: (1) the percentage of completion method or (2) the "percentage of completion-capitalized cost method". The term "long-term contract" is defined in the same manner as under the section 451 regulations of prior law.

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[88] Treas. Reg. sec. 1.451-3(d)(9)(vi).

Taxpayers using the percentage of completion method prior to the enactment of this provision are required to continue to use such method, unless such taxpayers obtain the consent of the Commissioner of Internal Revenue to change their method of accounting. Similarly, taxpayers using the completed contract method of accounting (or an inventory method of accounting for long-term contracts) are required to use the percentage of completion-capitalized cost method described below, unless such taxpayers obtain the consent of the Secretary of the Treasury to change their method of accounting.

Percentage of completion method

Under the percentage of completion method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year. The percentage of the contract completed during the taxable year is determined by comparing costs incurred with respect to the contract during the year with the estimated total contract costs.[89]

The contract costs taken into account in determining the percentage of completion are those for which capitalization is required under the extended period long-term contract rules, as modified by the Act (see discussion of "capitalizable contract costs," below, for description of these modifications). The physical completion method for determining the percentage of a contract completed during the year allowed under of prior law (Treas. Reg. sec. 1.451-3(c)(2)) is not permitted.

Costs incurred with respect to the long-term contract are deductible in the year incurred, subject to general accounting principles and limitations imposed under prior law, which continue to apply.[90]

In the taxable year in which the contract is completed, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if the actual gross contract price and the actual total contract costs, rather than the anticipated contract price and costs, had been used to compute gross income. Under this "lookback" procedure, interest must be paid by the taxpayer if there is an "underpayment" by the taxpayer with respect to a taxable year. Similarly, under the "lookback" method, interest will be paid to the taxpayer by the Internal Revenue Service if there is an "overpayment." The rate of interest for both underpayments and overpayments is the rate applicable to overpayments of tax under section 6621. For purposes of the "lookback" method, the contract price shall reflect all amounts received under the contract, including amounts received after the contract completion date as a result of disputes, litigation or settlements relating to the contract.

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[89] This calculation is done on a cumulative basis. Thus, the amount included in gross income in a particular year is that proportion of the expected contract price that the amount of costs incurred through the end of the taxable year bears to the total expected costs, reduced by amounts of gross contract price included in gross income in previous taxable years.

[90] *See, e.g.*, Treas. Reg. sec. 1.451-3(c)(3).

Percentage of completion-capitalized cost method

Under the percentage of completion-capitalized cost method, the taxpayer must take into account 40 percent of the items with respect to the contract under the percentage of completion method. The remaining 60 percent of the items under the contract are to be taken into account under the taxpayer's normal method of accounting. Thus, 60 percent of the gross contract income will be recognized, and 60 percent of the capitalizable contract costs will be deducted, at the time required by the taxpayer's method. For example, if the taxpayer uses the completed contract method of accounting, these items would be taken into account upon completion of the contract. Similarly, if the taxpayer uses the accrual shipment method, such contract items would be taken into account at the time of shipment.

The look-back method is applied to the 40 percent portion of the contract reported on the percentage of completion method. Thus, interest is paid to or by the taxpayer on the difference between the amount actually taken into account by the taxpayer for each year of the contract and the amount the taxpayer would have taken into account recomputing the 40-percent portion under the look-back method.

Capitalizable contract costs

Under the Act, capitalizable contract costs include all costs required to be capitalized under the extended period long-term contract regulations of prior law and, in some cases, interest. In addition, in the case of a cost-plus long-term contract or a contract with the Federal government, any costs identified by the taxpayer (or a related person) pursuant to the contract or Federal, state, or local law or regulation as being attributable to the contract are subject to capitalization. Independent research and development expenses, expenses for unsuccessful bids and proposals, and marketing, selling, and advertising expenses, however, are not subject to capitalization under this provision.

Independent research and development costs are defined as any expenses incurred in the performance of independent research and development other than (1) expenses directly attributable to a long-term contract in existence when the expenses are incurred, and (2) any expenses under an agreement to perform research and development.[91]

In addition, the Act provides that the contractual arrangement regarding independent research and development costs and their allocation to the contract shall not be severed, for Federal income tax purposes, from the long-term contract in such a manner as to render such costs ineligible for treatment as costs of a long-term contract, or to accelerate the recognition of any income pertaining to such costs in comparison to the recognition of income which would otherwise occur under the taxpayer's method of accounting.[92]

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[91] The Congress intended that any costs that qualify as independent research and development costs under the Federal Acquisition Regulations System, 48 C.F.R. sec. 31.205-18 (1985), will qualify under this provision.

Exception for small construction contracts

Under the Act, the required use of either the percentage of completion-capitalized cost method or the percentage of completion method does not apply to certain small construction contracts. Contracts within this exception are those contracts for the construction or improvement of real property if the contract (1) is expected to be completed within the two-year period beginning on the commencement date of the contract, and (2) is performed by a taxpayer whose average annual gross receipts for the three taxable years preceding the taxable year in which the contract is entered into do not exceed $10 million. Contracts eligible for this exception remain subject to the rules of prior law (i.e., the regulations applicable to non-extended period long-term contracts). Since such contracts involve the construction of real property, they are subject to the interest capitalization rules without regard to their duration.

Effective Date

The provisions of the Act are effective for contracts entered into after February 28, 1986.

For purposes of accounting for long-term contracts, the treatment of independent research and development costs (as includible in contract price but not includible in capitalizable contract costs) applies to all open taxable years of taxpayers.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $2,889 million in 1987, $3,297 million in 1988, $2,278 million in 1989, $969 million in 1990, and $609 million in 1991.

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[92] The Congress was aware that the treatment of independent research and development was a subject of controversy between taxpayers and the Internal Revenue Service. Under the Act, the position of the Internal Revenue Service in several recent technical advice memoranda was expressly overruled.

F. Reserve for Bad Debts (Sec. 805 of the Act and sec. 166 of the Code)[93]

Prior Law

Prior law permitted taxpayers to take a deduction for losses on business debts using either the specific charge-off method or the reserve method. The specific charge-off method allows a deduction at the time and in the amount that any individual debt is wholly or partially worthless. The reserve method allows the current deduction of the amount that is necessary to bring the balance in the bad debt reserve account as of the beginning of the year, adjusted for actual bad debt losses and recoveries, to the balance allowable under an approved method as of the end of the year. The deduction taken under the reserve method is required to be reasonable in amount, determined in light of the facts existing at the close of the taxable year.

Worthless debts are charged off, resulting in a deduction under the specific charge-off method, or an adjustment to the reserve account under the reserve method, in the year in which they become worthless. In the case of a partially worthless debt, the amount allowed to be charged off for Federal income tax purposes cannot exceed the amount charged-off on the taxpayer's books. No such requirement is applicable to wholly worthless debts.

Prior law required an actual debt be owed to the taxpayer in order to support the creation of a reserve for bad debts. An exception to this rule was provided for dealers who guarantee, endorse, or provide indemnity agreements on debt owed to others if the potential obligation of the dealer arises from its sale of real or tangible personal property.

Reasons for Change

The Congress believed that the use of the reserve method for determining losses from bad debts resulted in the deductions being allowed for tax purposes for losses that statistically occur in the future. Thus, the Congress believed that the use of the reserve method for determining losses from bad debts allowed a deduction to be taken prior to the time that the loss actually occurred. This treatment under prior law was not consistent with the treatment of other deductions under the all events test. If a deduction is allowed prior to the taxable year in which the loss actually occurs, the value of the deduction to the taxpayer is overstated and the overall tax liability of the taxpayer understated.

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[93] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 906; H. Rep. 99-426, pp. 638-641; H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 303; S. Rep. 99-313, pp. 153-158; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 314-316 (Conference Report).

Explanation of Provision

The Act repeals the availability of the reserve method in computing the deduction for bad debts for all taxpayers, other than commercial banks whose assets do not exceed $500 million, and thrift institutions. Thus, taxpayers (other than certain financial institutions) are required to use the specific charge-off method in accounting for losses on bad debts. The Act also repeals the reserve method for dealers who guarantee, endorse, or provide indemnity agreements with respect to debt obligations arising out of the sale by the dealer of real or tangible personal property in the ordinary course of business (sec. 166(f) of prior law). In determining whether a debt is worthless, the fact that a utility is required to continue to provide services to a customer whose account has otherwise been determined to be uncollectible will not be considered as evidence that the debt is not worthless for Federal income tax purposes.

The Congress has directed the Secretary of the Treasury to study and to issue a report regarding appropriate criteria to be used to determine if a debt is worthless for Federal income tax purposes. It is anticipated that the report will consider under what circumstances a rule providing for a conclusive or rebuttable presumption of the worthlessness of an indebtedness is appropriate.

The final report is to be submitted, by January 1, 1988, to the House Committee on Ways and Means and the Senate Committee on Finance.

Effective Date

The provision of the Act is effective for taxable years beginning after December 31, 1986. Any change from the reserve method of accounting for bad debts is treated as a change in method of accounting initiated by the taxpayer with the consent of the Secretary of the Treasury. The balance in any reserve for bad debts as of the effective date is generally to be included in income ratably over a four-year period. The amount to be included in income is the full balance of the reserve account, without offset for any anticipated amounts that will not be currently accrued as income under the rules allowing accrual basis service providers to exclude from income amounts that are statistically determined not to be collectible until such amounts are actually collected. (see VIII. A., supra). In the case of a bad debt reserve for guarantees, the amount of the reserve subject to inclusion is first reduced by the remaining balance in any suspense account established under section 166(f)(4) of prior law.

It was intended that (1) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; and (2) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized in taxable income ratably throughout the year in question.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1,209 million in 1987, $1,913 million in 1988, $1,837 million in 1989, $1,852 million in 1990, and $1,043 million in 1991.

G. Taxable Years of Partnerships, S Corporations, and Personal Service Corporations (Sec. 806 of the Act and secs. 706, 1378, 441, and 267 of the Code) [94]

Prior Law

Partnerships.—Prior law required a partnership adopting or changing a taxable year to use the same taxable year as all of its principal partners (or the calendar year, if all of the partnership's principal partners do not have the same taxable year and the partnership is adopting a taxable year), unless the partnership established to the satisfaction of the Secretary of the Treasury a business purpose for selecting a different taxable year (sec. 706). A partnership that adopted its taxable year prior to April 2, 1954, was not required to change its taxable year regardless of whether the taxable year adopted is the same as the taxable year of all of the principal partners (Treas. Reg. sec. 1.706-1(b)(6)).

In 1972, the Internal Revenue Service announced in Revenue Procedure 72-51 (1972-2 C.B. 832) that requests by a partnership to adopt or change to an accounting period differing from that of the principal partners generally will be approved where the adoption of such change would result in the deferral of income to the partners of three months or less.

S corporations.—Prior law required a corporation that made an election to be taxed as an S corporation, or an S corporation that changed its taxable year to adopt a "permitted year" (sec. 1378). A permitted year is a calendar year or any other accounting period for which the S corporation establishes a business purpose to the satisfaction of the Secretary of the Treasury. A corporation that was an S corporation for a taxable year that includes December 31, 1982 (or that was an S corporation for a taxable year beginning in 1983 by reason of an election made on or before October 19, 1982) was allowed to retain a taxable year that is not a permitted year. However, if more than 50 percent of the stock of such an S corporation is newly owned stock, the S corporation was required to change its taxable year to a permitted year. Revenue Procedure 83-25 (1983-1 C.B. 689) provides procedures that the Internal Revenue Service will follow in approving a request by a corporation electing S corporation status that desires to change, adopt, or retain a taxable year other than a calendar year. Revenue Procedure 83-25 provided that requests will be approved where the taxable year results in the deferral of income to shareholders of three months or less.

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[94] For legislative background of the provision, see: H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 304; S. Rep. 99-313, pp. 163-167; Senate floor amendment, 132 Cong. Rec. S 8190 (June 23, 1986); and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 317-320 (Conference Report).

Personal service corporations.—A personal service corporation generally was allowed to adopt any taxable year on its first Federal income tax return that conformed with its annual accounting period. A personal service corporation desiring to change its taxable year was generally required to first obtain the consent of the Secretary of the Treasury.

Deferral of income.—Under present law, partners in a partnership take into account their allocable share of income, gain, loss, deduction or credit of the partnership for their taxable year in which the partnership's taxable year ends. The items of income, gain, loss, deduction or credit are computed at the partnership level and reflect the partnership's (not the partner's) taxable year. To the extent that the partner's and the partnership's taxable years are not the same, a deferral of income can result. For example, assume a partnership has a taxable year ending in June, while an individual partner has a calendar year. The partner will include in his income tax return for the current calendar year his distributive share of partnership items that arose in the first six months of the current calendar year and his share of such items that arose in the last six months of the prior calendar year. Partnership items arising in the last six months of the current calendar year will not be included in the partner's return until the following calendar year. Thus, the recognition of six months' of partnership income has been deferred by the partner until the following taxable year.

A similar deferral may be accomplished through the use of a personal service corporation. For example, assume a personal service corporation with a taxable year ending in January pays its calendar year employee-owners a minimal salary during the year and, immediately prior to the close of the corporation's taxable year (during January), declares a bonus to the employee-owners equal to the profits of the corporation. The corporation obtains a deduction for the bonus paid (reducing its current year taxable income to zero) and the employee-owners report the bonus income as part of their income for the taxable year that ends eleven months later. The effect is to defer taxation on eleven months of income earned in one year until the following year.

Reasons for Change

The Congress believed that the prior law allowed an improper deferral of income for certain partners, shareholders in S corporations, and owners of personal service corporations. Where prior law allowed income earned by a partnership, S corporation or personal service corporation to be subjected to Federal income tax in a taxable year later than that in which it was earned, the value of the income earned is understated. This deferral of income was normally available only to certain types of taxpayers, resulting in preferential treatment of certain taxpayers at the overall expense of others. The Congress believed that requiring a partnership, S corporation, or personal service corporation to change its taxable year would impose less of a burden on the taxpaying public than other methods of eliminating the deferral.

Explanation of Provision

In general, the Act requires that all partnerships, S corporations, and personal service corporations conform their taxable years to the taxable years of their owners. An exception to the rule is made in the case where the partnership, S corporation, or personal service corporation establishes to the satisfaction of the Secretary of the Treasury a business purpose for having a different taxable year. The deferral of income to owners for a limited period of time, such as the three months or less rule of present law, is not to be treated as a business purpose.

The Act provides that a partnership may not have a taxable year other than the taxable year of the partners owning a majority interest in partnership profits and capital. If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership must adopt the same taxable year as its principal partners. If the principal partners of the partnership do not have the same taxable year and no majority of its partners have the same taxable year, the partnership must adopt a calendar year as its taxable year unless a different taxable year is provided by regulations. In each case, the partnership may use a different taxable year if it establishes to the satisfaction of the Secretary of the Treasury a business purpose therefor.

For example, assume a partnership has one principal partner which is a fiscal year corporation owning an interest of 10 percent in partnership profits and capital. The remainder of the partners are individuals on a calendar taxable year; none of these individuals owns a sufficient interest in the partnership to be a principal partner. Under prior law, the partnership would have been required to adopt the fiscal taxable year of the corporate partner (i.e., the taxable year of its principal partner). Under the Act, the partnership is required to adopt a calendar taxable year (i.e., the taxable year of the majority of its partners).

The Congress intended that a partnership not adopt the taxable year of the partners owning a majority interest in partnership profits and capital, unless partners with the same taxable year have owned a majority interest in partnership profits and capital for three consecutive taxable years of the partnership. This rule is to be phased-in over a three year period. In applying this rule, ownership in taxable years beginning before 1987 is not taken into account. If the taxable year of a partnership is determined by the taxable year of the partners owning a majority interest in partnership profits and capital, the Congress did not intend that a further change in the taxable year of the partnership be required for either of the two taxable years of the partnership following the year of change.[95]

An S corporation must adopt a calendar year, regardless of when the corporation elected to be taxed as an S corporation. Also, a personal service corporation must adopt a calendar year.

For purposes of this provision, a personal service corporation is a corporation the principal activity of which is the performance of personal service if services are substantially performed by employee-owners. An employee-owner is any employee of the corporation who owns any of the outstanding stock of the corporation. In determining whether an employee owns stock in the corporation, the constructive ownership rules of section 318 apply, except that the attribution of stock owned by a corporation to the employee is applied without regard to any requirement that the employee own a certain percentage of the value of the stock of that corporation. For the purpose of this provision, a corporation that has elected S corporation status will not be considered a personal service corporation.

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[95] A technical correction may be required to accomplish this result.

A corporation was not intended to be considered a personal service corporation for the purpose of this provision unless more than ten percent of the stock (by value) in such corporation is held by employee-owners.[96]

The Congress intended that a corporation engaged in the rendering of personal services be excluded from this definition only if the personal services rendered by owner-employees do not materially contribute to the revenue of the corporation. Review of other employees work by an owner-employee in his professional capacity constitutes contribution by the owner-employee with regard to the work reviewed.

The Congress intended that in the case of a corporation that is a member of an affiliated group filing a consolidated return, all members of such group are taken into account in determining whether or not such corporation meets the definition of a personal service corporation. For example, a corporation may be treated as a personal service corporation where the owner-employees rendering the requisites services are owners of the parent, but employees of a subsidiary. In determining if the principal activity of the corporation is the provision of personal services, the activities of all members of the consolidated group are to be considered.[97]

An exception to the rules requiring a certain taxable year is provided in each case where the partnership, S corporation, or personal service corporation establishes to the satisfaction of the Secretary of the Treasury a business purpose for having a different taxable year.

The Congress intended that any partnership that received permission to use a fiscal year-end (other than a year-end that resulted in a three-month or less deferral of income) under the provisions of Rev. Proc. 74-33, 1974-2 C.B. 489, be allowed to continue the use of such taxable year without obtaining the approval of the Secretary of the Treasury. Similarly, any S corporation that received permission to use a fiscal year-end (other than a year-end that resulted in a three-month or less deferral of income), which permission was granted on or after the effective date of Rev. Proc. 74-33, shall be allowed to continue the use of such taxable year without obtaining the approval of the Secretary of the Treasury.

Moreover, any partnership, S corporation, or personal service corporation may retain a taxable year, under procedures established by the Secretary of the Treasury, if the use of such year meets the requirements of the "25% test" as described in Rev.

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[96] A technical correction may be required to accomplish this intent.

[97] A technical correction may be required to accomplish this intent.

Proc. 83-25, 1983-1 C.B. 689 (i.e., 25% or more of the taxpayer's gross receipts for the 12-month period in question are recognized in the last two months of such period and this requirement has been met for the specified three consecutive 12-month periods).

In addition, the Secretary of the Treasury may prescribe other tests to be used to establish the existence of a business purpose, if, in the discretion of the Secretary of the Treasury, such tests are desirable and expedient towards the efficient administration of the tax laws. It was not the intent of the Congress that a partnership, S corporation or personal service corporation that does not meet the "25% test" be automatically denied the use of a taxable year other than the taxable year otherwise mandated by this provision. It is anticipated that the applications of all taxpayers will be considered based on each taxpayer's facts and circumstances.

The Congress intended that (1) the use of a particular year for regulatory or financial accounting purposes; (2) the hiring patterns of a particular business, e.g., the fact that a firm typically hires staff during certain times of the year; (3) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and (4) the fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis ordinarily will not be sufficient to establish that the business purpose requirement for a particular taxable year has been met. Although the above items are not themselves sufficient to establish a business purpose, they may be considered in connection with other items by the Secretary of the Treasury in determining whether a taxpayer has a business purpose for a particular taxable year. The fact that a particular fiscal year allows deferral of income for a limited period of time under no circumstances establishes a business purpose.

In determining the taxable year to which a taxpayer is required to change by reason of this provision, Congress intended that changes in taxable years of other persons required by the provision to change taxable years be taken into account. Such changes are to be taken into account regardless of the the time at which they take place, so long as they are determinable. For example, a partnership that historically used a January fiscal year has partners that are personal service corporations that historically used a June fiscal year. The personal service corporations are required to adopt a calendar year by this provision. Since the taxable year of the personal service corporation partners determines the taxable year of the partnership, the partnership also is required to adopt a calendar year.[98] The fact that the partners will be changing their taxable years is immaterial for the purpose of determining whether or not the majority interest test is met.

A partnership, S corporation, or personal service corporation that changes to a taxable year required by this provision will be treated as having made the change with the consent of the Secretary of the Treasury. In the case of a partnership or an S corporation required by this provision to change taxable years, each partner or owner that would otherwise be required to include items from more than one taxable year of the partnership or S corporation in any one of its taxable years is to take into account the excess of income over expenses for the short taxable year of the partnership or S corporation ratably in each of the first four taxable years of the partner or owner beginning after December 31, 1986, unless the partner or owner elects to include all such income in its taxable year that the short taxable years ends in or within. In the case of a personal service corporation, the taxable income in the short taxable year resulting from the change of taxable year is annualized under section 443.

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[98] If the change in the taxable year of the partnership did not take into account the change in the taxable year of its personal service corporation owners, the partnership could be considered to be required to first adopt a June year and later, after its partners had been required to adopt a calendar year, adopt the calendar year itself.

The rule allowing partners or shareholders of a partnership or S corporation to include items of income from the short year of the partnership or S corporation in each of the partner or shareholder's four taxable years beginning after December 31, 1986 is applicable regardless of what type of entity the partner or S corporation shareholder is. Thus, a personal service corporation that is a partner in a partnership required to adopt a new taxable year as a result of this provision is eligible to include the partner's distributive share of partnership income over four taxable years so long as it would otherwise be required to include the items from more than one taxable year of the partnership in any one of its taxable years. The rule is applicable to income from an S corporation only if such corporation was an S corporation for a taxable year beginning in 1986.

The ratable four year inclusion applies only in cases where the partner or S corporation shareholder would otherwise be required to include items from more than one taxable year of the partnership or S corporation in any one of its own taxable years. For example, a personal service corporation with a June fiscal year is a partner in a partnership that also uses a June fiscal year. Both the personal service corporation and the partnership are required to change to the calendar year. The changes are considered to occur simultaneously. In this case, the personal service corporation will include its share of partnership items from the last full fiscal year of the partnership in its full year ending in June, and its share of partnership items from the short year of the partnership in its short year (which is of equal length as the partnership's short taxable year). As the personal service corporation has not been required to include items from more than one taxable year in any one of its taxable years, the rule providing for ratable inclusion over four years of the excess of its share of partnership income in excess of expenses does not apply.

The Act extends the provisions of section 267 to provide that a personal service corporation and its employee-owners are treated as related taxpayers regardless of the amount of the corporation's stock owned, directly or indirectly, by the employee-owner. Thus, a personal service corporation may not deduct payments made to employee-owners prior to the time that such employee-owner would include the payment in gross income.

The Congress anticipated that the Secretary of the Treasury will promulgate regulations regarding the use of the 52-53 week taxable year to prevent the evasion of the principles of this provision. It is anticipated that the regulations will provide that, for the purpose of determining when taxable income is included by a partner or S corporation shareholder, a 52-53 week taxable year of a partner, shareholder, partnership, or S corporation will be treated as ending on the last day of the calendar month ending nearest to the last day of such 52-53 week taxable year. For example, a calendar year partner will include its share of taxable income from a partnership with a 52-53 week taxable year ending on January 3, 1988, in its 1987 calendar year Federal income tax return. The Secretary of the Treasury may also prescribe similar rules to prevent the evasion of the principles of the provision through the use of a 52-53 week taxable year by personal service corporations and the shareholder-employees of such corporations. It is also anticipated that the Secretary of the Treasury will suspend the operation of Treas. Reg. sec. 1.441-2(c) allowing taxpayers in certain cases to adopt, or change to, a 52-53 week taxable year without the approval of the Secretary of the Treasury.

Some partnerships and S corporations that adopted a taxable year providing a deferral of income to owners of three months or less were required to include the amount of deferral obtained in income over a 10-year period. Any portion of such amount not taken into income as of the effective date of the provision may be used to reduce the income attributable to any short taxable year required by the provision.

The Congress also intended that common trust funds taxed under section 584 of the Code be required to use a calendar year. To the extent a participant in a common trust fund is required to include items from more than one taxable year of the common trust fund in any of its taxable years, the items from the short taxable year of the common trust fund are to be included in income ratably over a four taxable year period, in the same manner as if the common trust fund were a partnership and the participant in the common trust fund were a partner.[99]

Effective Date

The provision is effective for taxable years beginning after December 31, 1986. Entities required to change their taxable years as a result of this provision will be required to file a return for the short taxable year that begins with the first day of their current taxable year beginning after December 31, 1986, and ends in accordance with the taxable year to which the entity changes.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $165 million in 1987, $467 million in 1988, $477 million in 1989, $390 million in 1990, and $213 million in 1991.

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[99] A technical correction may be required to accomplish this intent.

H. Special Treatment of Certain Items

1. Qualified discount coupons (sec. 823 of the Act and sec. 466 of the Code)[100]

Prior Law

Under prior law, issuers of qualified discount coupons using the accrual method of accounting could elect to deduct the cost of redeeming qualified discount coupons outstanding at the close of the taxable year so long as the coupons were received for redemption by the taxpayer within a statutory redemption period following the close of the taxable year (prior law sec. 466). The statutory redemption period was the 6-month period immediately following the close of the taxable year, unless the taxpayer elected a shorter period.

A qualified discount coupon was a coupon which (1) was issued by the taxpayer, (2) was redeemable by the taxpayer, and (3) allowed a discount on the purchase price of merchandise or other tangible personal property. The coupon could not have been redeemable directly by the issuer (i.e., a direct consumer rebate) and could not by itself, or in conjunction with any other coupons, have brought about a price reduction of more than $5 with respect to any item.

The election was required to be made with respect to each trade or business of the taxpayer and constituted a method of accounting. Revocation of an election could have been made only with permission of the Secretary of the Treasury. In certain situations, a taxpayer was required to establish a suspense account in the year of election in order to limit the bunching of deductions in that year.

Reasons for Change

The Congress believed that the provision of prior law allowing a deduction for discount coupons received for redemption after the close of the taxable year resulted in an incorrect measurement of taxable income. A coupon received during the redemption period was deductible in computing the prior year's income even though it may have related to the sale of a product which took place during the current taxable year and such a mismatch could have occurred even though the coupon was outstanding at the end of the prior taxable year. Thus, a deduction could have been allowed in the year prior to the year in which the income on the product for which the coupon was redeemed was recognized.

The Congress also believed that prior law provided an unwarranted exception to the general rules of tax accounting. An accrual basis taxpayer normally is allowed to recognize an expense only when all events establishing its obligation to pay the amount claimed as a deduction have occurred, the amount thereof can be determined with reasonable accuracy, and there has been economic performance with respect to the item. Absent the special provision of prior law for discount coupons, such costs would not have been considered deductible until the coupons actually were redeemed.

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[100] For legislative background of the provision, see: H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 324; S. Rep. 99-313, pp. 158-159; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 321-322.

Explanation of Provision

The Act repeals the special provision of prior law allowing a deduction for the cost of redeeming qualified discount coupons received during a redemption period after the close of the taxable year (prior law sec. 446). As a result, only those costs of redeeming discount coupons that are actually received for redemption during the taxable year will be allowed as a deduction during that taxable year.

The Act treats any taxpayer who previously had elected to deduct the cost of redeeming qualified discount coupons as having elected to change its method of accounting for discount coupons. The change will be considered to have been initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment which is required to be made by section 481 is reduced by any balance in the suspense account of the taxpayer, and the net amount is to be taken into account over a period not to exceed four taxable years, commencing with the first taxable year beginning after December 31, 1986. It is expected that the concepts of Revenue Procedure 84-74, 1984-2 C.B. 736, generally will apply to determine the actual timing of recognition of income or expense as a result of the adjustments arising from this provision. It also is expected that (1) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; and (2) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized in taxable income ratably throughout the year in question.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $16 million in 1987, $31 million in 1988, $34 million in 1989, $35 million in 1990, and $21 million in 1991.

2. Income attributable to utility services (sec. 821 of the Act and sec. 451 of the Code)[101]

Prior Law

Under both present and prior law, taxpayers using an accrual method of accounting recognize income at the time all the events have occurred which establish the taxpayer's right to receive the income and the amount of income can be established with reasonable accuracy.

Under prior law, utilities using an accrual method of accounting were allowed to recognize income in the taxable year in which a customer's utility meter was read, providing a similar technique was used for financial accounting purposes (Rev. Rul. 72-114, 1972-1 C.B. 124). Some judicial decisions rendered prior to the enactment of the Act allowed income to be recognized in the taxable year in which a customer's utility meter was read regardless of the technique used for financial accounting purposes. *See, e.g., Orange and Rockland Utilities* v. *Commissioner*, 86 T.C. No. 14 (1986).

Reasons for Change

The Congress believed that a method of accounting that recognized income in accordance with an event other than the provision of utility services did not accurately measure the taxable income of an accrual basis utility. Methods of accounting that recognized income at the time a customer's utility meter was read or at the time the customer was billed fail to recognize income as it was earned and resulted in a mismatching of income and expense. The continued allowance of such methods of accounting would have provided an unwarranted exception to the rules of accounting applicable to other taxpayers.

In addition, the Congress also was aware that the proper method of accounting for utility services by an accrual basis utility was then a matter of controversy between taxpayers and the Internal Revenue Service. In order to minimize disputes over prior taxable years, the Congress believed that a method of accounting that took into account income from the provision of utility services on the basis of the accounting period in which the customers' meters were read should be accepted for those prior years.

Explanation of Provision

The Act requires accrual basis taxpayers to recognize income attributable to the furnishing or sale of utility services to customers not later than the taxable year in which such services are provided to the customer. The year in which utility services are provided may not be determined by reference to the time the customer's meter is read or to the time that the customer is billed (or may be billed) for such services.

The effect of the provision is to require an estimate of the income attributable to utility services provided during the taxable year but after the final meter reading or billing date which falls within the taxable year. It is anticipated that, where it is not practical for the utility to determine the actual amount of services provided through the end of the current year, this estimate may be made by assigning a pro rata portion of the revenues determined as of the first meter reading date or billing date of the following taxable year.

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[101] For legislative background of the provision, see: H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 322; S. Rep. 99-313, pp. 120-121; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 322-324 (Conference Report).

Utility services subject to the provision of the Act are the provision of electrical energy, water or sewage disposal, the furnishing of gas or steam through a local distribution system, telephone and other communications services, and the transportation of gas or steam by pipeline. The Congress anticipated that similar rules also would be applicable to other utility services which might come into existence at some future date. Whether or not a utility service is regulated by a government or governmental agency does not affect its treatment under this provision.

It is expected that taxpayers required to accrue income at the time that utility services are furnished to customers also will be able to accrue at such time any deductions for the related costs of providing the utility services, so long as economic performance has occurred with respect to such costs in the year in question.

The Act provides that, for any taxable year beginning before August 16, 1986, a method of accounting which took into account income from the providing of utility services on the basis of the period in which the customers' meters were read shall be deemed to be proper for Federal income tax purposes. The Congress also intended such a method to be deemed proper for Federal income tax purposes for a taxable year beginning after August 16, 1986 and before January 1, 1987, if the taxpayer used such method for its preceeding taxable year.[102] Such a method is deemed to be proper only if that method was actually used by the taxpayer for the preceeding taxable year. No inference is intended as to whether or not such a method is proper if the method is retroactively adopted by the taxpayer. No inference is intended as to other methods of accounting for utility services (e.g., a method of accounting which takes income into account on the basis of the date the customer is billed for utility services or a hybrid method that combines the recognition of income at the time customers' meters are read with another method). Also, no inference is intended with regard to other questions of law, including but not limited to the treatment of prepaid income amounts for the provision of utility services at a future date, the treatment of deposits made by utility customers, or the treatment of amounts received by a taxpayer under a "budget-billing" procedure.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986. The amount of any adjustment required to be made as a result of this provision is to be included in income ratably over the first four taxable years for which the provision is effective.

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[102] A technical correction may be necesary to reflect this intention.

It also is anticipated that (1) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; and (2) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized in taxable income ratably throughout the year in question.

In the case of a taxpayer that has delayed the deductions of related costs of providing the utility services in order to match such costs with the period in which income is recognized, the change in accounting method required under this provision will include any change in accounting method for the related items of expense or deduction necesary in order to allow the deduction of these items in the same period as the related income is recognized. This change in method of accounting, however, is limited to items of expense or deduction for which economic performance has occurred within the taxable year in question. The net amount of the two changes is taken into income ratably over a 4-year period.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $191 million in 1987, $356 million in 1988, $384 million in 1989, $387 million in 1990, and $200 million in 1991.

3. Contributions in aid of construction (sec. 824 of the Act and secs. 118(b) and 362(c)(3) of the Code)[103]

Prior Law

Under both present and prior law, the gross income of a corporation does not include contributions to its capital (sec. 118(a)). Under prior law, a corporate regulated public utility that provides electric energy, gas (through a local distribution system or transportation by pipeline), water, or sewage disposal services was allowed to treat contributions received in aid of construction as a contribution to capital not includible in gross income (sec. 118(b)). Such contributions could not have been included in the utility's rate base for rate making purposes. Property received (or purchased with the proceeds of) a contribution to capital had no depreciable basis for Federal income tax purposes and was not eligible for the investment tax credit.

Reasons for Change

The Congress believed that all payments that are made to a utility either to encourage, or as a prerequisite for, the provision of services should be treated as income of the utility and not as a contribution to the capital of the utility. The Congress believed that prior law allowed amounts that represented prepayments for services to be received by corporate regulated public utilities without the inclusion of such payments in gross income. Accordingly, the Act repeals the prior law treatment and requires the recipient utility to include the value of such contributions in income at the time of their receipt and to depreciate the value of any asset contributed, or purchased with a contribution of cash, over the recovery period of the asset.

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[103] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 908; H. Rep. 99-426, pp. 643-645; and H. Rep. 99-841, Vol. II (September 18, 1986), p. 324 (Conference Report).

Explanation of Provision

The Act repeals the provision of prior law (sec. 118(b)) that provided that contributions in aid of construction received by a corporate regulated public utility be treated as a contribution to the capital of the utility.

Congress intended that the effect of the change be to require a utility to report as an item of gross income the value of any property, including money, that it receives to provide, or to encourage it to provide, services to, or for the benefit of, the person transferring the property to the utility. A utility is considered as having received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services, if the receipt of the property results in the provision of services earlier than would have been the case had the property not been received, or if the receipt of the property otherwise causes the transferor to be favored in any way.

Congress intended that a utility include in gross income the value of the property received regardless of whether the utility had a general policy, stated or unstated, that requires or encourages certain types of potential customers to transfer property, including money, to the utility while other types of potential customers are not required or encouraged to make similar transfers. If members of a group making transfers of property are favored over other members of the same general group not making such transfers, the fact that the contributing members of the group may not be favored over the members of other groups in the receipt of services will not prevent the inclusion of the value of the transfer in the gross income of the utility. For instance, where a utility generally requires developers of multiple tracts of residential housing to transfer property to the utility in order to obtain service, but does not require such a transfer from individual homeowners, the fact that both groups will receive service without preference of one group over the other will not prevent the utility from being required to include in gross income the value of the property received from the developers. Where all members of a particular group make transfers of property to the utility, normally it will be assumed that such transfers are to encourage the provision of services, despite the absence of any formal policy requiring such transfers, unless it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfers.

The person transferring the property will be considered as having been benefitted if he is will receive the services, is an owner of the property that will receive the services, is a former owner of the property that will receive the services, or derives any benefit from the property that will receive the services. Thus, a builder who transfers property to a utility in order to obtain services for a house that he was paid to build will be considered as having benefitted from the provision of the services. This is the case despite the fact that the builder may never have had an ownership interest in the property and may make the transfer to the utility after the house has been completed and accepted.

A transfer of property to the utility from a person benefitting from the services will be deemed to occur under this provision if such treatment is in accordance with the substance of the transaction, regardless of the form in which such transaction is conducted. For example, a transfer of property to the utility may occur even though the person benefitting from the services nominally retains legal title to such property, if the the effect of the transaction is to transfer to rights and burdens of ownership to the utility. Similarly, a transfer of property from a real estate developer to obtain services for a tract being developed will be deemed to occur even though such transaction is arranged in the form of a loan from the developer to the utility, unless adequate interest is charged on the moneys lent. Where repayment of a loan to a utility is contingent, it is normally expected that a taxable transfer of property will be considered to have occurred, if the contingent loan is made to allow or to encourage the utility to provide services for the benefit of the person making the contingent loan. To the extent that income is recognized by the utility in such a case, it is anticipated that a deduction will be allowed for repayment in the period in which the repayment is made. The amount of any such deduction should reflect any depreciation deductions that may have previously been taken with regard to the property transferred (or purchased with the proceeds of the transfer).

The value of property transferred to a utility, and thus the amount required to be included in income, is its fair market value. Fair market value is to be determined in the same manner as for the purpose of determining gain or loss when property is received in a sale or exchange. That is, the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell. This amount may be different than the cost to the transferor of constructing or acquiring the property transferred. Whether or not the value of the property transferred is allowed to be included in the rate base of the transferee, or the depreciation on the property transferred is allowed as an expense for the purpose of determining if the transferee is earning an adequate return on its rate base, is not intended to be a determinant of the transferred property's value.

A sale of property to a utility at less than fair market value or its lease to a utility for less than a fair market rental is treated as a taxable transfer as a result of this provision.

The provision does not effect transactions that would not have been treated as nontaxable contributions in aid of construction under section 118(b) of prior law. For example, a transaction that qualifies as a like-kind exchange under section 1031, or that qualifies as an involuntary conversion under section 1033 is taxed under those sections and not as a taxable transfer under this provision.

Effective Date

The provision is effective for contributions received after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $70 million in 1987, $125 million in 1988, $110 million in 1989, $104 million in 1990, and $103 million in 1991.

4. Cancellation of indebtedness for solvent taxpayers (sec. 822 of the Act and sec. 108 of the Code)[104]

Prior Law

Under both present and prior law, gross income includes "income from discharge of indebtedness" (sec. 61(a)(12)). A discharge of indebtedness is considered to occur whenever a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt. The amount of indebtedness discharged is equal to the difference between the face amount of the debt, adjusted for any unamortized premium or discount, and any consideration given by the taxpayer to effect the discharge. Both present and prior law contain exceptions to the general rule in cases where the discharge occurs in a case arising under title 11 of the United States Code (relating to bankruptcy) or when the taxpayer is considered to be insolvent.

Prior law also provided an exception where the indebtedness discharged was qualified business indebtedness (sec. 108(a)(1)). Qualified business indebtedness was indebtedness that was incurred or assumed by a corporation or indebtedness that was incurred or assumed by an individual in connection with property used in the individual's trade or business. A taxpayer was required to elect to have the indebtedness treated as qualified business indebtedness (sec. 108(d)(4)).

In the case of a discharge of qualified business indebtedness, the amount of the discharge that would have been included in gross income had the discharge not been of qualified business indebtedness was instead applied to reduce the basis of depreciable property of the taxpayer (sec. 108(c)(1)). An election was available to treat inventory as depreciable property for this purpose. The amount of discharge income that could have been excluded as a discharge of qualified business indebtedness was limited to the basis of the taxpayer's depreciable property. If the amount of discharge income exceeded the basis of depreciable property, the excess was required to be included in gross income for the year in which the discharge occurred.

Reasons for Change

The Congress believed that the prior law treatment of the discharge of qualified business indebtedness was too generous. Income from such a discharge generally was deferred by reducing the basis of depreciable assets, regardless of the capacity of the taxpayer to currently pay the tax. In addition, the provision produced disparate results among taxpayers depending upon the makeup of their depreciable assets. For taxpayers without sufficient amounts of inventory or depreciable assets, the full benefit of the deferral was not available.

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[104] For legislative background of the provision, see: H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 323; S. Rep. 99-313, pp. 161-162; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 324-325 (Conference Report).

Explanation of Provision

The Act repeals the provision of prior law (sec. 108(a)(1)(C)) which provided for the exclusion from gross income of income from the discharge of qualified business indebtedness. The effect of the Act is to require that any discharge of indebtedness, other than a discharge in title 11 cases and a discharge that occurs when the taxpayer is insolvent, results in the current recognition of income in the amount of the discharge.

The Congress did not intend to change the present law treatment of a discharge of indebtedness that occurs in a title 11 case or when the taxpayer is insolvent.[105] The Congress also did not intend to change the provision of prior and present law (sec. 108(e)(5)) that treats any reduction of purchase-money debt of a solvent debtor as a purchase price adjustment, rather than a discharge of indebtedness.

Effective Date

The provision is applicable to discharges of indebtedness occurring after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $60 million in 1987, $85 million in 1988, $67 million in 1989, $57 million in 1990, and $46 million in 1991.

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[105] Sec. 405 of the Act provides special rules for certain solvent farmers for the purpose of determining whether there is income from the discharge of indebtedness. (See Title IV., Part A.4).

TITLE IX—FINANCIAL INSTITUTIONS

A. Reserves for Bad Debts (Sec. 905 of the Act and secs. 585, 586, and 595 of the Code) [1]

1. Commercial banks

Prior Law

In general

Under prior law, all commercial banks[2] were allowed to use either the specific charge-off method or the reserve method in computing their deduction for bad debts for Federal income tax purposes. A commercial bank using the specific charge-off method takes a deduction for bad debt expense at the time a specific debt becomes partially or totally worthless in the amount of such worthlessness. A commercial bank using the reserve method takes a deduction for bad debt expense at the close of the taxable year. The amount of the deduction is limited to the amount necessary to increase the year-end balance of the bad debt reserve account to an amount computed under either the "bank experience method" or the "percentage of eligible loans method." A commercial bank may switch between the bank experience method and the percentage of eligible loans method of determining the addition to its reserve for losses on loans from one year to another.

Bank experience method

The maximum allowed ending reserve balance for a bank using the bank experience method is the amount of loans outstanding at the close of the taxable year times a fraction, the numerator of which is the sum of actual bad debts for the current and five preceding taxable years, and the denominator of which is the sum of the amount of loans outstanding at the close of the each of those years.

Percentage of eligible loans method

The maximum allowed ending reserve balance for a bank using the percentage of eligible loans method is equal to a specified percentage of the outstanding eligible loans at the close of the taxable year, plus an amount determined under the bank experience method for loans other than eligible loans. The specified percentage for taxable years beginning after 1982 is 0.6 percent.[3] Eligible loans for this purpose generally are loans incurred in the course of a bank's normal customer loan activities on which there is more than an insubstantial risk of loss.[4]

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 801; H. Rep. 99-426, pp. 574-583; H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 801; S. Rep. 99-313, pp. 285-288; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 326-332 (Conference Report).

[2] A commercial bank is defined as a domestic or foreign corporation, a substantial portion of whose business consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted national banks, and who are subject by law to supervision and examination by State or Federal authority having supervision over banking institutions (sec. 581). For the purpose of determining the deduction for bad debts, the term "commercial bank" does not include domestic building and loan associations, mutual savings banks, or cooperative nonprofit mutual banks ("thrift institutions").

The availability of the percentage of eligible loans method expires after 1987. For taxable years beginning after 1987, banks are limited to the bank experience method in computing additions to bad debt reserves.

Under both the bank experience method and the percentage of eligible loans method, the ending reserve balance need not be less than the balance at the end of the "base year," providing that the amount of outstanding loans at the close of the current year is at least as great as the balance at the close of the base year.

If the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec. 291). Also, 59 and 5/6ths percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

Reason for Change

The Congress believed that the reserve method of accounting for bad debts generally should be repealed for several reasons. First, the use of the reserve method for determining losses on bad debts results in deductions being taken currently for tax purposes for losses that statistically are expected to occur in the future. In this regard, the reserve for bad debts is inconsistent with the treatment of other deductions under the all events test. Second, the use of the reserve method allows deductions to be taken prior to the time that the losses actually occur and, therefore, allows deductions larger than the actual present value of the losses. Finally, the Congress is concerned that many banks, particularly those who are members of large banking organizations, have used the reserve method for determining losses from bad debts to lower substantially their Federal income tax liabilities.

At the same time, the Congress was concerned that the repeal of the reserve method for smaller banks may have a potentially adverse impact. The Congress sought to balance these concerns by providing for the continued availability of reserves for bad debts for smaller banks, as under prior law, while requiring larger banks to compute their losses from bad debts using the specific charge-off method.

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[3] For taxable years beginning after 1975 and before 1982, the specified percentage was 1.2 percent. For taxable years beginning in 1982, the specified percentage was 1.0 percent.

[4] Specifically excluded from the definition of an eligible loan are a loan to a bank; a loan to a domestic branch of a foreign corporation which would be a bank were it not a foreign corporation; a loan secured by a deposit in the lending bank or in another bank if the taxpayer bank has control over the withdrawal of such deposit; a loan to or guaranteed by the United States, a possession or instrumentality thereof, or to a State or political subdivision thereof; a loan evidenced by a security; a loan of Federal funds; and commercial paper. Sec. 585(b)(4).

Explanation of Provision

Repeal of reserve method for large banks

The Act repeals the use of reserves in computing the deduction for losses on bad debts in the case of "large banks." A bank is considered a "large bank" if, for the current taxable year or any taxable year beginning after December 31, 1986, the sum of the average adjusted bases of all assets of such bank (or any controlled group of which the bank is a member) exceeds $500 million. The adjusted basis of an asset generally will be considered to be the tax basis of the asset, adjusted by those amounts allowed as adjustments to basis by section 1016. In determining the sum of the average adjusted bases of all assets of a controlled group, interests held by one member of such group in another member of such group are to be disregarded.

The average adjusted bases of the assets of a bank or controlled group is the average of the adjusted bases of the assets for each period of time falling within the taxable year the bank is required to report for regulatory purposes. This is expected to result in the adjusted bases of the assets of a bank generally to be determined quarterly, at the same time as the quarterly call reports for the bank are prepared, regardless of whether or not the end of any such quarter coincides with the end of the taxable year of the bank.

A controlled group for this purpose is a controlled group of corporations described in section 1563(a)(1). For the purpose of determining the sum of the adjusted bases of the assets of a controlled group, all corporations includible in the group under the ownership tests of section 1563(a) are included, without regard to their status as an "excluded member" of a controlled group as a result of the application of section 1563(b)(2), whether or not the corporation meets the definition of a commercial bank, and whether or not the corporation is a foreign or domestic entity.

Recapture of existing bad debt reserves

Direct recapture inclusion method.—A commercial bank that is determined to be a large bank generally is required to include in income the balance in any reserve for bad debts over a period of four taxable years, beginning with the disqualification year. The disqualification year is the first taxable year beginning after December 31, 1986, for which the bank is considered to be a large bank. Ten percent of the reserve balance is included in income in the disqualification year, 20 percent in the first taxable year following the disqualification year, 30 percent in the second following year, and 40 percent in the third taxable year following the disqualification year. The bank may elect to include in income a greater amount in the first year for which recapture is required. If such an election is made, 2/9ths of the remainder of the reserve balance (after reduction for the amount included in income in the first taxable year) must be included in income in the second taxable year, 1/3rd of the remainder in the third taxable year, and 4/9ths of the remainder in the fourth taxable year.

A bank, that is directly recapturing its existing bad debts reserve by including an amount in taxable income, may suspend the inclusion in income of its bad debt reserve for any year in which it is a "financially troubled bank." Nonetheless, a financially troubled bank may elect to include in income currently all or a portion of the amount of its reserves that otherwise would be recaptured that year.

A bank is a financially troubled bank if the average of its nonperforming loans for the taxable year exceeds 75 percent of the average of its equity capital for the year. Nonperforming loans include (1) loans that are "past due 90 days or more and still accruing," (2) "nonaccrual" loans, and (3) "renegotiated 'troubled' debt" under the existing standards of the Federal Financial Institution Examination Council. Equity capital is assets less liabilities, as those amounts are reported for regulatory purposes. Equity capital does not include the balance in any reserve for bad debts. The average of nonperforming loans and equity capital for the year is to be determined as the average of those amounts at each time during the taxable year that the bank is required to report for regulatory purposes. In the case of a bank that is a member of a controlled group described in section 1563(a)(1), the determination of whether the bank is a financially troubled bank is made with respect to all members of that controlled group.

The inclusion in income of a portion of the bad debt reserve is suspended, not forgiven, during each year in which the bank is considered to be a financially troubled bank. For example, consider a large bank that is financially troubled in the disqualification year, is not financially troubled in the two following years, and then returns to financially troubled status in the fourth year. No portion of the bank's bad debt reserve need be included in income during the disqualification year, since the bank meets the definition of a financially troubled bank. In the second year, the bank must begin the inclusion of its bad debt reserve in income. As the inclusion in income begins in this year, the bank may include in income either 10% of its reserve balance or a greater amount if it so elects. The bank may not elect at this time to use the cut-off method (described below), since it has already tolled the inclusion of the bad debt reserve in income as a financially troubled bank. In the third year, the bank must include in income 2/9ths of the bad debt reserve not included in income in the prior year. The bank returns to troubled status in the fourth year and no portion of the bad debt reserve must be included in income in that year. The bank will be required to include in income the amount it would have included in that year in the next year in which it is not a financially troubled bank.

The provision allowing a financially troubled bank to suspend the inclusion of its bad debt reserve in income does not affect the requirement that a large bank account for its bad debts using the specific charge-off method.

Cut-off method.—In lieu of the recapture of its bad debts reserves by including them in income, the bank may elect to use the cut-off method with regard to its outstanding loans at the time it becomes a large bank. The election to use the cut-off method is made on a taxpayer-by-taxpayer basis. Thus, commercial banks that join in a consolidated Federal income tax return with other commercial banks must follow any election made by the consolidated group to use the cut-off method, and may not independently elect the use of the cut-off method unless the consolidated group makes such an election. On the other hand, in the case commercial banks which are affiliated but that do not file a consolidated return, each commercial bank can elect the cut-off method regardless of whether other members of the affiliated group also elect the cut-off method.

A commercial bank electing to use the cut-off method is required to segregate its outstanding loans into two accounts. One account consists of loans created on or after the first day of the disqualification year. The specific charge-off method is required to be used in computing the deduction for bad debts attributable to the loans in this account. The second account consists of loans that were outstanding on the last day of the taxable year before the disqualification year. The deduction for bad debts attributable to the loans in this account continues to be determined using the reserve method. All charge-offs and recoveries on loans in the second account are adjustments to the reserve account and not separate items of income and expense. However, if the charge-off of any loan would reduce the balance in any reserve account below zero, the charge-off shall be an adjustment to the reserve account only in the amount necessary to reduce the balance in such account to zero. Any charge-offs in excess of such reserve balance, and any recoveries with regard to such loans, will be items of income and expense in the year of charge-off or recovery, as if the taxpayer had always used the specific charge-off method. Under the cut-off method, no additional deductions in the disqualification year or thereafter are allowable for additions to the reserve for bad debts.

Unless the balance of a reserve account has been reduced to zero by the adjustment required for a charged-off item, the allowable ending balance for the reserve account is computed for year end by taking into account only those debts which were outstanding on the last day of the taxable year before the disqualification year. No additional deductions may be taken for an addition to restore the reserve account to its allowable ending balance.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

2. Thrift institutions

Prior Law

General rule

Under both present and prior law, mutual savings banks, domestic building and loan associations, and cooperative banks without capital stock which are organized and operated for mutual purposes and without profit (collectively called "thrift institutions") are allowed to use either the specific charge-off method or the reserve method in computing their deduction for bad debts for Federal income tax purposes. For thrift institutions using the reserve method, the reasonable addition to the reserve for bad debts under prior law was equal to the addition to the reserve for losses computed under the "bank experience" method, the "percentage of eligible loans" method, or, if a sufficient percentage of the thrift institution's assets constitute "qualified assets," the "percentage of taxable income" method. A thrift institution may switch between methods of determining the addition to its loan loss reserve from one year to another.

Permissible methods

Experience and percentage of eligible loans methods.— The bank experience and percentage of eligible loans methods for thrift institutions generally were the same as for commercial banks (discussed above).

Percentage of taxable income method.—Under the percentage of taxable income method, an annual deduction is allowed for a statutory percentage of taxable income.[5] The statutory percentage under prior law for tax years beginning after 1978 was 40 percent.

The full 40-percent of taxable income deduction was available only where 82 percent (72 percent in the case of mutual savings banks without capital stock) of the thrift institution's assets were qualified. Where the 82-percent test was not met, the statutory rate was reduced by three-fourths of one percentage point for each one percentage point of such shortfall. For mutual savings banks without capital stock, the statutory rate was reduced by one and one-half percentage points for each percentage point that qualified assets were less than the 72-percent requirement. At a minimum, 60 percent of a thrift institution's assets must have been qualified (50 percent for mutual savings banks without stock) in order for the thrift institution to have been eligible for deductions under the percentage of income method.

Corporate preferences and minimum tax

Under prior law, if the deduction for bad debts for the taxable year determined under the above rules exceeded the amount which would have been allowed as a deduction on the basis of actual experience, the deduction was reduced by 20 percent of such excess (sec. 291). Also, 59 and 5/6ths percent of the deductible excess (after the 20-percent reduction) was treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

Small business investment companies

Under prior law, small business investment companies operating under the Small Business Investment Act of 1958 and business development companies were allowed to use the reserve method of computing their deduction for bad debts. The allowable ending balance in the reserve account was determined using the bank experience method (prior law sec. 586).

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[5] For purposes of determining the deduction under the percentage of taxable income method, taxable income is computed without regard to any deduction allowable for any addition to the reserve for bad debts and exclusive of 18/46 of any net long-term capital gain, gains on assets the interest on which was tax-exempt, any dividends eligible for the corporate dividends received deduction and any additions to gross income from the thrift institution's own distributions from previously accumulated reserves.

Reasons for Change

Since the last time that the Congress has reviewed the taxation of thrift institution and other financial institutions,[6] there have been several changes in regulatory policies that have expanded the activities in which thrift institutions may engage, and at the same time encouraged other institutions to expand their activities in areas which were traditionally serviced by the thrift institutions. These changes have resulted in other financial institutions being in direct competition with thrift institutions, while prior law provided significantly different tax treatment of these financial institutions.[7] Such policies are not promoted by providing a substantially lower effective tax rate for one competitor than for others.

Accordingly, the Congress believed that the benefit of prior law, which allowed a bad debt deduction to thrift institutions equal to 40 percent of taxable income, should be substantially reduced. The Congress continued to believe that there should be some incentive for thrift institutions to provide residential mortgage loans, and that the provision of a bad debt deduction equal to a reduced percentage of taxable income should be available only to those thrift institutions maintaining a sufficient percentage of qualified assets, including residential mortgage loans.

In reducing, rather than eliminating, the percentage of taxable income method for thrift institutions, the Congress intended to continue to encourage such institutions to continue to hold a significant percentage of the type of assets traditionally held by thrift institutions (i.e., residential mortgage loans) which qualify the institution as a thrift institution while not providing those institutions with a significant competitive advantage over other financial institutions.

The Congress believed that the reasons for preserving a limited deduction for bad debts using the reserve method that was provided for thrift institutions and for commercial banks other than large banks should not be extended to small business investment companies or to small business development companies. These companies do not generally accept, and are not responsible for, the safety of deposits from the general public. The Congress determined, therefore, that small business investment and development companies should be treated the same as those other companies that provide loans from funds other than those deposited by the public (such as finance companies or investment capital companies) that may not use the reserve method of computing losses from bad debts under the Act.

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[6] Until 1952, thrift institutions were exempt from Federal income tax. In 1952, the Congress repealed the exemption of these institutions and subjected them to the regular corporate income tax. At that time, however, these institutions were allowed a special deduction for additions to bad debt reserves which proved to be so large that thrift institutions remained virtually tax exempt. In 1962, the Congress established an alternative 60-percent of taxable income deduction for bad debts. Savings and loan associations were eligible for the full deduction only if 82 percent of their assets were invested in qualifying assets. Mutual savings banks were not subjected to the 82-percent test. In 1969, the Congress established the basics of the prior law (described above) by providing that a thrift institution could determine its deduction for bad debts under either of the methods allowed commercial banks (the bank experience and the percentage of eligible loans methods) as well as the alternative of the percentage of taxable income method. The 60-percent rate in place at the time of the 1969 legislation was phased down at a rate of 3 percent per year until it reached 40 percent in 1979. The requirement that a percentage of the thrift institution's assets be qualifying assets was extended to mutual savings banks in 1969. In passing the 1969 legislation, the Congress was concerned that the previous bad debt reserve provisions for thrift institutions were unduly generous, allowing a much lower effective rate of tax than the average effective rate for all corporations.

[7] The effect of the present-law 40-percent deduction, in combination with the 20-percent disallowance for corporate preferences, is to provide a maximum effective tax rate of 31.28 percent to thrift institutions, while other corporations are subject to a maximum effective tax rate of 46 percent. The effect of continuing the 40-percent deduction and the 20-percent disallowance for corporate preferences in combination with the 34-percent maximum corporate rate in the Act would have been to provide a maximum tax rate of 23.12 percent to thrift institutions.

Explanation of Provision

Thrift institutions (mutual savings banks, domestic building and loan associations, and cooperative banks) continue to be able to compute their bad debt deductions using the bank experience method and the percentage of taxable income method. The percentage of eligible loans method is no longer available. In using the percentage of taxable income method, the portion of taxable income which may be deducted as an addition to a reserve for bad debts is reduced from 40 percent to 8 percent. The rules reducing the amount of the percentage of taxable income deduction available to a thrift institution which holds 60 percent of its assets in qualifying assets, but fails to hold a sufficient percentage of qualifying assets to use the maximum percentage of taxable income deduction, are eliminated. Any institution meeting the definition of a thrift institution and holding at least 60 percent of its assets as qualifying assets, is eligible for the full 8 percent of taxable income deduction. The 60-percent test applies to mutual savings banks as well as other types of thrift institutions.

An entity previously treated as a thrift institution that does not meet the new definition of thrift institution (under the 60 percent test) generally is treated as a commercial bank if it otherwise satisfies the definition of section 581. An entity previously treated as a thrift institution now treated as a commercial bank is subject to the tax rules applicable to commercial banks. If the adjusted bases of the assets of the entity (or any controlled group of which the entity is a member) exceed $500 million, such an entity would be considered a large bank and ineligible to use the reserve method of computing deductions for losses on bad debts. The existing bad debt reserve of such an entity is required to be recaptured using either the direct recapture inclusion method or the cut-off method. If the adjusted bases of the assets of the entity (or any controlled group of which the entity is a member) do not exceed $500 million, the entity is considered a commercial bank other than a large bank and continues to be eligible to use the reserve method of computing deductions for losses on bad debts under the bank experience method.

Thrift institutions that claim the 8 percent of taxable income deduction allowed by the Act are not to be treated as having a tax preference for purposes of the 20-percent reduction of section 291. The excess of the percentage of taxable income deduction over the deduction that would have been allowable on the basis of actual experience will be treated as a preference item for the purpose of computing the corporate minimum tax (sec. 57).

The provision of prior law (sec. 586) that allowed small business investment companies operating under the Small Business Investment Act of 1958 and business development companies to use the reserve method of computing losses on bad debts is repealed.

Effective Date

The provisions are effective for taxable years beginning after December 31, 1986.

Revenue Effect of Reserves for Bad Debts

The provisions effecting the bad debts reserves of commercial banks, thrift institutions, and small business investment and development companies are estimated to increase fiscal year budget receipts by $647 million in 1987, $1,092 million in 1988, $1,218 million in 1989, $1,406 million in 1990, and $631 million in 1991.

B. Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations (Sec. 902 of the Act and secs. 265 and 291 of the Code)[8]

Prior Law

In general

Prior and present law (sec. 265(2))[9] disallow a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from Federal income tax (tax-exempt obligations). This rule applies both to individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues interest expense and a related person acquires or holds tax-exempt obligations (sec. 7701(f)).[10]

Application to taxpayers generally

The Internal Revenue Service (IRS) and the courts have consistently interpreted section 265(2) to disallow an interest deduction only when a taxpayer incurs or continues indebtedness for the purpose of acquiring or holding tax-exempt obligations.[11] They have employed various tests to determine whether a taxpayer has the prohibited purpose. In general, when a taxpayer has independent business or personal reasons for incurring or continuing debt, the taxpayer has been allowed an interest deduction regardless of his tax-exempt holdings. When no such independent purpose exists, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed.

In *Wisconsin Cheeseman, Inc., v. United States,* 388 F. 2d 420 (7th Cir. 1968), an interest deduction was disallowed for a corporation which made short-term bank loans to meet recurrent seasonal needs for funds, pledging tax-exempt securities as collateral. The court held that the taxpayer could not automatically be denied a deduction because it had incurred indebtedness while holding tax-exempt obligations. However, use of the securities as collateral established a sufficiently direct relationship between the loans and the purpose of carrying tax-exempt securities. The court stated further that a deduction should not be allowed if a taxpayer could reasonably have foreseen, at the time of purchasing tax-exempt securities, that a loan would probably be required to meet ordinary, recurrent economic needs.

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[8] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 802; H. Rep. 99-426, pp. 584-91; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 332-34 (Conference Report).

[9] The Act redesignates this provision as section 265(a)(2).

[10] In addition to interest deductions, prior and present law (sec. 265(a)(1) as redesignated by the Act) deny a deduction for nonbusiness expenses for the production of tax-exempt interest income, which expenses would otherwise be deductible under section 212. This may include, for example, brokerage and other fees associated with a tax-exempt portfolio. Prior and present law also disallow deductions for certain expenses of mutual funds which pay tax-exempt dividends, and for interest used to purchase or carry shares in such a fund.

[11] Legislative history indicates that Congress intended the purposes test to apply. *See, e.g.*, S. Rep. No. 617, 65th Cong., 3d Sess. pp. 6-7 (1918); S. Rep. No. 398, 68th Cong., 1st Sess. p. 24 (1924); S. Rep. No. 558, 73d Cong., 2d Sess. p. 24 (1934).

In Rev. Proc. 72-18, 1972-1 C.B. 740, the IRS provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations.[12]

Under Rev. Proc. 72-18, a deduction is disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations. This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such obligations are used as collateral for indebtedness, as in *Wisconsin Cheeseman*, above. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations. A deduction generally is not disallowed for interest on an indebtedness of a personal nature (e.g., residential mortgages) or indebtedness incurred or continued in connection with the conduct of an active trade or business. Generally, a purpose to carry tax-exempt obligations will be inferred, unless rebutted by other evidence, if an individual holds tax-exempt indebtedness which is not directly connected with personal expenditures or the conduct of an active trade or business.

Under Rev. Proc. 72-18, when there is direct evidence of a purpose to purchase or carry tax-exempt obligations, no part of the interest paid or incurred on the indebtedness (or on that portion of the indebtedness directly traceable to the holding of particular tax-exempt obligations) may be deducted. In other cases, an allocable portion of interest is disallowed, to be determined by multiplying the total interest on the indebtedness by the ratio of the average adjusted basis during the taxable year of the taxpayer's tax-exempt obligations to the average adjusted basis of the taxpayer's total assets.

Rev. Proc. 72-18 provides specifically that dealers in tax-exempt obligations are denied an interest deduction when they incur or continue indebtedness for the purpose of holding tax-exempt obligations, even if such obligations are held for resale.[13] When dealers incur or continue indebtedness for the general purpose of carrying on a brokerage business, which includes the purchase of both taxable and tax-exempt obligations, an allocable portion of interest is disallowed. However, the disallowance rule generally does not apply when indebtedness is incurred to acquire or improve physical facilities. The revenue procedure does not specify under what circumstances, if any, a bank is to be treated as a dealer in tax-exempt obligations.

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[12] That is, those situations not covered by Rev. Proc. 70-20, 1970-2 C.B. 499, discussed below.

[13] See, *Leslie v. Commissioner*, 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970). The court in *Leslie* held specifically that the effective exemption of banks from the disallowance provision (discussed below) did not apply to a brokerage business.

Application to financial institutions

The legislative history of section 265(2) suggests that Congress did not originally intend the disallowance provision to apply to the indebtedness incurred by a bank or similar financial institution to its depositors.[14] The IRS took the position as early as 1924 that indebtedness to depositors was not incurred to purchase or carry tax-exempt obligations, within the meaning of the law. In Rev. Rul. 61-22, 1961-2 C.B. 58, the IRS restated its position that the provisions of the law "have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be 'indebtedness incurred or continued to purchase or carry obligations * * *' within the meaning of section 265."

Despite this general rule, the IRS attempted under prior law to disallow interest deductions of financial institutions in certain cases. Rev. Rul. 67-260, 1967-2 C.B. 132, provided that a deduction would be disallowed when a bank issues certificates of deposit for the specific purpose of acquiring tax-exempt obligations. The ruling concerned a bank which issued certificates of deposit in consideration of, and in exchange for, a State's tax-exempt obligations, the certificates having approximately the same face amount and maturity dates as the State obligations.

In Rev. Proc. 70-20, 1970-2 C.B. 499, the IRS issued guidelines for application of the disallowance provision to banks holding tax-exempt State and local obligations. Rev. Proc. 70-20 provided that a deduction would not be disallowed for interest paid or accrued by banks on indebtedness which they incurred in the ordinary course of their day-to-day business, unless there were circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. The IRS would ordinarily infer that a direct connection did not exist (i.e., a deduction would ordinarily be allowed) in cases involving various forms of short-term indebtedness,[15] including deposits and certificates of deposit; short-term Eurodollar deposits and borrowings; Federal funds transactions and similar interbank borrowing; repurchase agreements; and borrowing directly from the Federal Reserve to meet reserve requirements. Within these categories, unusual facts and circumstances outside of the normal course of business could demonstrate a direct connection between the borrowing and the investment in tax-exempt securities; in these cases, a deduction would be disallowed. The IRS would not infer a direct connection merely because tax-exempt obligations were held by the bank at the time of its incurring indebtedness in the course of its day-to-day business.

Under Rev. Proc. 70-20, application of the disallowance provision to long-term capital notes was to be resolved in the light of all the facts and circumstances surrounding the issuance of the notes. A deduction was not to be disallowed for interest on indebtedness created by the issuance of capital notes for the purpose of increasing capital to a level consistent with generally accepted banking practices.

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[14] *See*, S. Rep. No. 558, 73d Cong., 2d Sess. p. 24 (1934); S. Rep. No. 830, 88th Cong., 2d Sess. p. 80 (1964).

[15] For purposes of the revenue procedure, "short-term bank indebtedness" meant indebtedness for a term not to exceed three years. A deposit for a term exceeding three years was treated as short-term when there was no restriction on withdrawal, other than loss of interest.

Types of borrowings not specifically dealt with by Rev. Proc. 70-20 were to be decided on a facts and circumstances basis. Additionally, Rev. Proc. 72-18, discussed above, was applicable to financial institutions in situations not dealt with in Rev. Proc. 70-20.[16]

After the issuance of Rev. Proc. 70-20, several cases and rulings addressed the treatment under prior law of bank deposits or similar arrangements which were secured or collateralized by tax-exempt obligations. These decisions generally refrained from applying the disallowance provision to the facts of those cases.

Rev. Proc. 78-34, 1978-2 C.B. 535, allowed a deduction for interest paid by commercial banks on borrowings of Treasury tax and loan funds when those borrowings were secured by pledges of tax-exempt obligations. The IRS took the position that this type of borrowing was in the nature of a demand deposit.

In *Investors Diversified Services, Inc., v. United States,* 573 F. 2d 843 (Ct. Cl. 1978), the court found that the use of tax-exempt securities as collateral for face-amount certificates[17] was not sufficient evidence of a purpose to purchase or carry tax-exempt obligations and, therefore, allowed an interest deduction. Noting various similarities between banks and face-amount certificate companies, the court held that the rationale for the "bank exception" to the disallowance provision was equally applicable to these companies. The court cited three further grounds for holding the disallowance provision inapplicable: (1) that the sale of certificates (i.e., borrowing) was wholly separate from and independent of the company's investment process, including the acquisition and maintenance of tax-exempt securities; (2) that the essential nature of the company's business was the borrowing of money which had to be invested in order to pay off the certificate holders; and (3) that the company could not reduce its borrowings by disposing of its tax-exempt securities, since only the certificate holders had the power to terminate each certificate.

Further, in *New Mexico Bancorporation v. Commissioner,* 74 T.C. 1342 (1980), the Tax Court permitted a bank a deduction for interest paid on repurchase agreements which were secured by tax-exempt State and municipal obligations. The court concluded that the repurchase agreements were similar to other types of bank deposits, and were not the type of loans or indebtedness intended to be covered by the disallowance provision. Furthermore, the bank's purpose for offering repurchase agreements was independent of the holding of tax-exempt obligations.[18]

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[16] Rev. Proc. 70-20 was modified by Rev. Proc. 83-91, 1983-2 C.B. 618, to provide that a deduction would generally not be disallowed in the case of repurchase agreements collateralized by tax-exempt securities (as well as agreements collateralized by taxable obligations). This modification was in response to the decision in *New Mexico Bancorporation v. Commissioner,* 74 T.C. 1342 (1980) (discussed below).

[17] Face-amount certificates are certificates under which the issuer agrees to pay to the holder, on a stated maturity date, at least the face amount of the certificate, including some increment over the holder's payments. Prior law (sec. 265(2)) provided that interest paid on face-amount certificates by a registered face-amount certificate company was not to be considered as interest incurred or continued to purchase or carry tax-exempt obligations, to the extent that the average amount of tax-exempt obligations held by such institution during the taxable year did not exceed 15 percent of its average total assets. The *Investors Diversified Services* case involved a face-amount certificate company whose tax-exempt holdings exceeded 15 percent of its total assets.

20-percent reduction in preference items

Under a provision originally added by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and later modified by the Deficit Reduction Act of 1984, the amount allowable as a deduction with respect to certain financial institution preference items was reduced by 20 percent. (The original TEFRA rule provided for a 15-percent reduction.) Under prior law, financial institution preference items included interest on indebtedness incurred or continued by financial institutions[19] to purchase or carry tax-exempt obligations acquired after December 31, 1982, to the extent that a deduction would otherwise be allowable for such interest. Unless the taxpayer (under regulations to be prescribed by the Treasury) established otherwise, the 20 percent reduction applied to an allocable portion of the taxpayer's aggregate interest deduction, to be determined by multiplying the otherwise allowable deduction by the ratio of the taxpayer's average adjusted basis of tax-exempt obligations during the year in question to the average adjusted basis of the taxpayer's total assets. For example, a bank which invested 25 percent of its assets in tax-exempt obligations was denied a deduction for $5,000 of each $100,000 of interest paid to its depositors during the taxable year (20 percent x $25,000 interest allocable to debt used to acquire or hold tax-exempt obligations). For purposes of this provision, interest specifically included amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares, whether or not formally designated as interest.

Reasons for Change

The Congress believed that the prior law treatment of financial institutions for purposes of the interest disallowance rule should be changed for two reasons. First, the prior law rules, by allowing financial institutions to deduct interest payments regardless of tax-exempt holdings, discriminated in favor of financial institutions at the expense of other taxpayers. Second, the Congress was concerned that financial institutions could drastically reduce their tax liability as a result of the prior-law rules. For example, under prior law, a bank often could totally eliminate its tax liabilities by investing as little as one-third or less of its assets in tax-exempt obligations.

To correct these problems, the Act denies financial institutions an interest deduction in direct proportion to their tax-exempt holdings. The Congress believed that this proportional disallowance rule is appropriate because of the difficulty of tracing funds within a financial institution, and the near impossibility of assessing a financial institution's "purpose" in accepting particular deposits. Congress believed that the proportional disallowance rule would place financial institutions on approximately an equal footing with other taxpayers.

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[18] Rev. Proc. 80-55, 1980-2 C.B. 849, would have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations. The revenue procedure concerned banks that participated in a State program that required the banks to bid for State funds and negotiate the rate of interest, and required the State to leave such deposits for a specified period of time. The IRS took the position that direct evidence of a purpose to purchase or carry tax-exempt obligations existed in such transactions under Rev. Proc. 72-18.

Rev. Proc. 80-55 was revoked by Rev. Proc. 81-16, 1981-1 C.B. 688. However, Rev. Proc. 81-16 stated that the disallowance provision would continue to apply to interest paid on deposits that are incurred outside of the ordinary course of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations.

[19] The provision applied to commercial banks (including U.S. branches of foreign banks), mutual savings banks, domestic building and loan associations, and cooperative banks.

While desiring to change the prior-law rules, the Congress was concerned about the effect of the new rules on smaller localities which depend on financial institutions to buy tax-exempt bonds for bona fide governmental projects. To limit any potential increased borrowing costs to such localities, the Act provides a permanent "small issuer" exception, allowing up to $10 million in bonds per local issuer (including subordinate entities) to be exempt from the 100-percent disallowance rule. This exception is limited to bonds for governmental or charitable (i.e., section 501(c)(3) organization) purposes. The Act also exempts from the new disallowance rule tax-exempt obligations acquired pursuant to binding commitments entered into by financial institutions on or before September 25, 1985, to purchase or repurchase such obligations.

Explanation of Provision

100-percent disallowance of financial institution interest expense allocable to tax-exempt obligations

The Act denies banks, thrift institutions, and other financial institutions a deduction for that portion of the taxpayer's otherwise allowable interest expense that is allocable to tax-exempt obligations acquired by the taxpayer after August 7, 1986. The amount of interest allocable to tax-exempt obligations generally is determined as it was for purposes of the 20-percent reduction in preference items under prior law, after taking into account any interest disallowed under the general rules applicable to all taxpayers (sec. 265(2) of prior law and sec. 265(a)(2) under the Act). Thus, a deduction is denied for that portion of a financial institution's otherwise allowable interest deduction that is equivalent to the ratio of (1) the average adjusted basis (within the meaning of sec. 1016)[20] during the taxable year of tax-exempt obligations held by the financial institution and acquired after August 7, 1986, to (2) the average adjusted basis of all assets held by the financial institution. For example, if an average of one-third of a financial institution's assets during the taxable year consists of tax-exempt obligations acquired after August 7, 1986, the financial institution is denied one-third of its otherwise allowable interest deduction. This allocation rule is mandatory and cannot be rebutted by the taxpayer.

Under the Act, the 20-percent disallowance rule of prior law continues to apply with respect to tax-exempt obligations acquired between January 1, 1983, and August 7, 1986. Thus, a financial institution reduces its otherwise allowable interest deduction in any year by the sum of (1) 100 percent of interest allocable to tax-exempt obligations acquired after August 7, 1986, and (2) 20 percent of interest allocable to tax-exempt obligations acquired between January 1, 1983, and August 7, 1986, each determined under the formula above. For example, if 25 percent of a bank's assets consists of tax-exempt obligations acquired after August 7, 1986, and an additional 25 percent consists of tax-exempt obligations acquired in 1983, 1984, 1985, or the first portion of 1986 (i.e., before August 8 of that year), the bank would be denied 30 percent of its otherwise allowable interest deduction (i.e., 25 percent attributable to obligations acquired after August 7, 1986, and 5 percent (.20 x 25 percent) attributable to obligations acquired between January 1, 1983, and August 7, 1986).

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[20] This adjusted basis is reduced by the basis of any debt which is used to purchase or carry tax-exempt obligations under section 265(a)(2).

Financial institutions subject to the rule include any entity which (1) accepts deposits from the public in the ordinary course of its trade or business, and (2) is subject to Federal or State supervision as a financial institution. It is intended that this will include (but not necessarily be limited to) banks, mutual savings banks, domestic building and loan associations, cooperative banks, and any other entities to which the prior law 20-percent disallowance provision (sec. 291) applied. In addition, the 100-percent disallowance rule specifically applies to foreign banks doing business within the United States (sec. 585(a)(2)(B)).

Interest, the deduction of which is subject to the rule, includes amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares, whether or not such amounts are officially designated as interest. Tax-exempt obligations include shares in regulated investment companies (i.e., mutual funds) which distribute exempt-interest dividends during the recipient's taxable year.

For purposes of the disallowance rule, the acquisition date of an obligation is the date on which the holding period begins with respect to the obligation in the hands of the acquiring financial institution. Thus, the acquisition of bonds as part of a tax-free reorganization is not treated as a new acquisition for purposes of this provision.

The Act specifies that, where new section 263A (relating to required capitalization of preproductive expenses including interest and taxes) applies to a portion of the interest expense of a financial institution,[21] the disallowance of interest allocable to tax-exempt obligations is to be applied before the rules of section 263A. For example, assume that a bank has $100 million of interest expense, $25 million of which consists of construction period interest subject to section 263A, and that one-half the bank's assets consist of tax-exempt obligations acquired after 1985. The bank's $100 million interest expense would first be reduced by one-half under the disallowance rule with respect to tax-exempt obligations. Of the remaining $50 million of interest expense, $25 million would be capitalized under section 263A.

The preference for interest income on tax-exempt private activity bonds, for purposes of the individual and corporate minimum taxes, is reduced by the amount of interest expense disallowed under section 265 (see Title VII, above). This includes amounts disallowed under the general rules applicable to all taxpayers (sec. 265(a)) or the 100 percent disallowance rule for financial institutions.

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[21] A description of this provision is found in Title VIII., Part D., above.

Exception for certain small issuers

The Act provides an exception to the 100-percent disallowance rule for qualified tax-exempt obligations acquired by a financial institution. This exception applies whether the obligation is acquired at the original issuance of the obligation or by a subsequent purchaser.

Under the Act, qualified tax-exempt obligations include any obligation which (1) is not a private activity bond as defined by the Act (*see*, Title XIII, below),[22] and (2) is issued by an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds, as defined above) during the calendar year. For purposes of this computation, all tax-exempt obligations (other than private activity bonds, as defined above) which the issuer reasonably anticipates to issue during the calendar year are taken into account.[23] Qualified tax-exempt obligations must be designated as such by the issuer; not more than $10 million of obligations may be so designated by any issuer (including subordinate entities, as described below) for any calendar year. Refundings of outstanding bonds qualify for the small issuer exception under the same terms as new issues.

For purposes of the exception for qualified tax-exempt obligations, an issuer and all subordinate entities are treated as one issuer. Subordinate governmental entities include entities deriving their issuing authority from another entity or subject to substantial control by another entity. For example, a sewer or solid waste authority created by a city or county in order to issue bonds for that city or county is considered a subordinate entity. Similarly, an "on behalf of" issuer is treated as a subordinate entity. Under this rule, if a city and all on behalf of issuers reasonably anticipate to issue an aggregate of more than $10 million in tax-exempt obligations (other than private activity bonds, as defined above) during the calendar year, neither the city not any of its on behalf of issuers qualify for the exception. An entity is not to be considered subordinate solely because of geographic inclusion in a larger entity (e.g., a city located within a larger county), if the smaller entity derives its powers independently of the larger entity and is not subject to significant control by the larger entity.

Qualified tax-exempt obligations are treated as acquired by the financial institution before August 8, 1986. Interest allocable to such obligations remains subject to the 20-percent disallowance contained in prior law.

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[22] For purposes of the small issuer exception only, qualified 501(c)(3) bonds (as defined in Title XIII of the Act) are not treated as private activity bonds. In the case of bonds issued on or before August 15, 1986, for purposes of this provision only, bonds are not to be treated as private activity bonds if they are not IDBs, mortgage revenue bonds, student loan bonds, or other private ("consumer") loan bonds for which tax exemption was permitted under prior law.

[23] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in H. Con. Res. 395 as passed by the House and Senate in the 99th Congress.

Repeal of special treatment of face-amount certificate companies

In connection with the changes above, the special rule of prior law relating to face-amount certificate companies is repealed. These companies are therefore subject to the disallowance rules above in the same manner as other financial institutions.

Effective Date

This provision generally is effective in taxable years of financial institutions ending after December 31, 1986. Obligations acquired after August 7, 1986, in taxable years ending during 1986, result in a 20-percent disallowance (under prior law) for the taxable year ending in 1986, but in a 100-percent disallowance in subsequent taxable years.

A transitional exception is provided for tax-exempt obligations acquired after August 7, 1986, pursuant to a direct or indirect written commitment to purchase or repurchase such obligation, which commitment was entered into on or before September 25, 1985. Obligations qualifying for this exception are treated as if acquired before August 8, 1986; interest allocable to such obligations thus remains subject to the 20-percent disallowance contained in prior law.

The Act also provides transitional rules for obligations to finance certain specifically identified projects. Interest allocable to such obligations also remains subject to the 20-percent disallowance rule contained in prior law.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $51 million in 1986, $50 million in 1987, and $5 million in 1988, and to decrease fiscal year budget receipts by $17 million in 1989 and $34 million in 1990.

C. Special Rules for Net Operating Losses of Financial Institutions (Sec. 903 of the Act and sec. 172 of the Code) [24]

Prior Law

Under prior law, commercial banks or thrift institutions (mutual savings banks, domestic building and loan associations, and cooperative banks) may carry net operating losses (NOLs) back to the prior 10 taxable years and forward to the succeeding five taxable years. Under both present and prior law, other taxpayers generally may carry net operating losses back to the prior three taxable years and forward to the succeeding 15 taxable years.

Reasons for Change

The Congress believed that net operating losses incurred by financial institutions, such as commercial banks and thrift institutions, should be treated in the same manner as net operating losses incurred by other taxpayers. However, the Congress was aware that the immediate application of such a change to commercial banks in concert with the repeal of the reserve method of computing a deduction for bad debts could have an unnecessarily adverse impact upon the deferred tax accounts that such taxpayers keep for financial and regulatory accounting purposes. Accordingly, the ten year carryback period of prior law is retained for such taxpayers for taxable years beginning before 1994 for the portion of a net operating loss attributable to deductions for bad debts.

The Congress was concerned that thrift institutions that had incurred large net operating losses in years prior to the Act not be encouraged to engage in overly risky activities or to reorganize with other taxpayers in order to use the net operating losses within the prior law carry forward period. The Congress believed that an extension of the carryforward period by an additional three years is a preferable approach to encouraging overly risky activities or reorganizations that are motivated by tax rather than economic considerations. The Congress believed that an additional three-year carryforward period for such losses was appropriate because the three additional years permit a total carryover period (i.e., 18 years) equal to that available to taxpayers generally. The Congress believed that the potential inability to use net operating losses is most pronounced for losses incurred during taxable years beginning during the period 1982 to 1985, and that it is appropriate to limit the additional carryforward period to those taxable years.

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[24] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 803; H. Rep. 99-426, p. 592; H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 802; S. Rep. 99-313, pp. 289-290; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 335-336 (Conference Report).

Explanation of Provision

The Act repeals the special rules permitting financial institutions to carry net operating losses back to the prior 10 taxable years and forward to the succeeding five taxable years. Thus, financial institutions generally are subject to the general rule allowing taxpayers to carry net operating losses back to the preceeding three taxable years and forward to the succeeding 15 taxable years.

Net operating losses incurred by a thrift institution in taxable years beginning after December 31, 1981, and before January 1, 1986, may be carried back to the prior 10 taxable years and carried forward to the succeeding eight taxable years.

A special 10-year carryback provision is provided for commercial banks that are required to compute their deduction for bad debts using the specific charge-off method as a result of the Act. The portion of net operating losses for any taxable year beginning after December 31, 1986, and before January 1, 1994, that is attributable to deductions for bad debts is carried back to the prior 10 taxable years and carried forward to the succeeding five taxable years. The portion of the net operating loss of a commercial bank attributable to deductions for bad debts is the excess of the net operating loss for the taxable year over the net operating loss for such taxable year computed without regard to any deductions for bad debts. The special 10-year carryback provision does not apply to either a commercial bank that continues to compute its deduction for bad debts using the reserve method or to a thrift institution. An entity that was previously treated as a thrift institution now treated as a large commercial bank (and thus not allowed to use the reserve method of computing a deduction for bad debts) is subject to this special 10-year carryback provision.

The special 10-year carryback provision is provided in place of the normal rules requiring a net operating loss to be carried back three years and carried forward 15 years. A commercial bank subject to the special 10-year carryback provision may elect to relinquish the entire carryback period as part of an election to relinquish any carryback for all net operating losses arising within a taxable year.

The availability of criteria of these provisions is determined by the status of the entity in the year in which the net operating loss arises.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $59 million in 1988, $93 million in 1989, $92 million in 1990, and $77 million in 1991.

D. Repeal of Special Rules for Reorganizations of Financially Troubled Thrift Institutions (Sec. 904 of the Act and secs. 368, 382, and 597 of the Code)[25]

Prior Law

In general

Prior law provided special rules designed to provide relief to financially troubled thrift institutions. These provisions, added by the Economic Recovery Tax Act of 1981,[26] provided that the continuity of interest requirement was met if the depositors of the financially troubled thrift institution were depositors of the surviving corporation, allowed the carryover of net operating losses of a financially troubled thrift institution where its depositors continued as depositors of the acquiring corporation, and exempted certain payments from the Federal Savings and Loan Insurance Corporation (FSLIC) to financially troubled thrift institutions from income and the general basis reduction requirement of the Internal Revenue Code.

Tax-free reorganization status

Under both present and prior law, in order for a combination of two corporations to be a tax-free "reorganization" within the meaning of section 368(a), a judicially created continuity of interest rule must be satisfied. The continuity of interest rule generally requires that the shareholders of an acquired corporation retain a meaningful ownership interest in the acquiring corporation.[27] If the transaction fails to qualify as a tax-free reorganization, the acquired corporation and its shareholders may recognize gain or loss on the transaction, and the acquiring corporation generally takes a cost basis in the acquired corporation's assets. If the transaction qualifies as a tax-free reorganization, the acquired corporation and its shareholders generally recognize no gain and the acquiring corporation assumes the acquired corporation's basis.

It was unclear prior to the 1981 Act whether a merger of an insolvent thrift institution into a solvent thrift institution could comply with the "continuity of interest" rule, expecially where one of the institutions was mutually owned. For example, in Rev. Rul. 69-3, 1969-1 C.B. 103, the Internal Revenue Service ruled that a merger of a mutual savings and loan association into another mutual savings and loan association qualified as a tax-free reorganization. Nonetheless, a case decided by the Supreme Court after the 1981 Act, but relating to facts occuring prior to the 1981 Act, held that a merger of a stock savings and loan into a mutual savings and loan failed to qualify as a tax-free reorganization. The Court held that continuity of interest did not exist because the depositors in the acquired institution (whose savings accounts were converted into accounts in the acquiring institution) received essentially cash plus an insubstantial equity interest.[28]

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[25] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 804; H.Rep. 99-426, pp. 593-595; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 336 (Conference Report).

[26] Pub. L. 97-34, 97th Cong., 1st Sess. (1981); referred to as the "1981 Act".

[27] See *Penellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462, 468-470; Treas. Reg. secs. 1.368-1(b), 1.368-2(a).

Under the 1981 Act, the continuity of interest requirement need not be satisfied in the case of a merger involving a thrift institution, provided certain conditions are met. First, the acquired institution must be one to which section 593 applies, namely, a savings and loan association, a cooperative bank, or a mutual savings bank. Second, the FSLIC or the Federal Home Loan Bank Board (FHLBB) (or, if neither has jurisdiction, an equivalent State authority) must certify that the thrift institution is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. Third, substantially all of the liabilities of the transferor institution (including deposits) must become liabilities of the transferee. If these conditions are satisfied, the acquired institution need not receive or distribute stock or securities of the acquiring corporation for the transaction to qualify as a tax-free reorganization (sec. 368(a)(3)(D)). The legislative history of the 1981 amendments made it clear that the provision covered all possible combinations of stock and mutual thrift institutions, including stock acquiring mutual, stock acquiring stock, mutual acquiring mutual, and mutual acquiring stock.

Net operating loss carryovers

Where a tax-free reorganization of two corporations occurs, the acquiring corporation generally succeeds to the tax attributes of the acquired corporation, including its net operating loss carryovers, subject to certain limitations in section 382. Under prior-law section 382, the ability of an acquiring corporation to succeed to the net operating loss carryovers of a corporation acquired in a tax-free reorganization was limited to the extent the owners of the acquired corporation fail to acquire stock in the acquiring corporation representing at least 20 percent of the value of the latter's stock (sec. 382(b)).

The 1981 Act provided that depositors in a thrift institution that had been certified as financially troubled whose deposits carry over to the acquiring corporation would be deemed to have continued an equity interest in the thrift inastitution to the extent of their deposits. Thus, any losses of the thrift institution were less likely to be reduced under the loss limitation provisions of section 382.

FSLIC contributions

Under both present and prior law, although contributions to capital by nonshareholders are excluded from the income of the recipient corporation (sec. 118), the basis of property normally must be reduced by such contributions (sec. 362(c)). The status of contributions from the FSLIC as either taxable income or as a contribution to capital was unclear prior to the 1981 Act. The 1981 Act provided that certain financially troubled thrift institutions need not reduce their basis for money or property contributed by the FSLIC under its financial assistance program, and such amounts were not includible in income (sec. 597).

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[28] *Paulsen* v. *Commissioner*, 105 S. Ct. 627 (1985).

Reasons for Change

The stated purpose of the special rules in the 1981 Act relating to financially troubled thrift institutions was to provide favorable tax rules to aid those institutions, their depositors, and the institutions that insure their deposits. The Congress believed that these 1981 Act rules were inconsistent with the policies of normal tax rules that otherwise would apply to those institutions. Moreover, the Congress believed that these special rules were unfair since they provided beneficial treatment to a selected class of beneficiaries. Accordingly, the Congress believed that, after a two-year transitional period, financially troubled thrift institutions should no longer receive the preferential tax treatment accorded by the 1981 Act.

Explanation of Provision

The Act repeals the special provisions enacted in the 1981 Act relating to acquisitions of financially-troubled thrift institutions, and the exclusion from income and the basis reduction requirement of FSLIC payments to such thrift institutions, effective after December 31, 1988.[29] Accordingly, acquisitions and reorganizations after that date involving financially troubled thrift institutions will be subject to the generally applicable rules.

The Act also provides that no deduction may be disallowed under section 265(a)(1), relating to expenses allocable to tax-exempt income, for any amount paid or incurred by a taxpayer on the ground such amount is allocable to amounts excluded under section 597.

Effective Date

The repeal of the special reorganization rules is effective for acquisitions or mergers occurring after December 31, 1988. The exclusion for certain FSLIC payments is repealed for payments received in taxable years beginning on or after the same date. An exception is provided, however, for payments made pursuant to an acquisition or merger that occurs before January 1, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $46 million in 1989, $105 million in 1990, and $164 million in 1991.

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[29] For discussion of amendments to Code section 382, see Title VI., Part F., *supra*.

E. Treatment of Losses and Interest on Deposits in Insolvent Financial Institutions (Sec. 905 of the Act and secs. 165 and 451 of the Code) [30]

Prior Law

Under prior law, a loss experienced by a taxpayer with respect to a deposit in a financial institution was treated in the same manner as any other bad debt loss. Deduction of the loss was generally allowable only in the year in which it is determined, based on all the facts and circumstances, that there was no prospect of recovery. Unless the deposit in the financial institution was created or acquired in connection with a trade or business of the taxpayer, any loss on the deposit constituted a short-term capital loss (sec. 166(d)). An individual taxpayer generally may deduct short-term capital losses only to the extent of $3,000 plus his capital gains for the year (sec. 1211).

Reasons for Change

The Congress believed that the circumstances surrounding deposits in financial institutions are different from the circumstances surrounding other debts owed to a taxpayer. Depositors in financial institutions often use such accounts for temporary safekeeping of funds that are needed for food, rent, and other essential items, rather than for investment. In most cases, these funds are deposited with the expectation that they may be withdrawn on demand.

The Congress believed that an individual should be allowed an election to deduct the loss arising from the insolvency of a financial institution at the time that the loss becomes reasonably estimable. Moreover, it felt that the loss is better viewed as a casualty loss than as a short-term capital loss, and should receive the same treatment as a casualty loss for Federal income tax purposes.

In addition, the Congress believed that interest that is credited to a depositor's account in an insolvent financial institution that, due to the institution's insolvency, cannot be withdrawn, should not be includible in the depositor's income (or deductible by the institution) until the interest is subject to withdrawal.

Explanation of Provision

Losses on deposits

The Act allows qualified individuals to elect to deduct losses on deposits in qualified financial institutions as casualty losses in the year in which the amount of such loss can be reasonably estimated.[31] A qualified individual is any individual other than an owner of one percent or more of the value of the stock of the institution in which the loss was sustained, an officer of such institution, and certain persons related to such owners and officers. Relatives of one-percent owners and officers who are not considered as qualified individuals are siblings (whether by whole or half blood), spouses, aunts, uncles, nephews, nieces, ancestors, and lineal descendants. Other persons are considered to be related to a one-percent owner or officer if they are a related persons under the provisions of section 267(b).

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[30] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 805; H.Rep. 99-426, pp. 596-597; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 803; S.Rep. 99-313, pp. 291-292; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 291-292 (Conference Report).

A qualified financial institution is any commercial bank (as defined in sec. 581), any thrift institution (as defined in sec. 591), any insured credit union, or any institution similar to the above which is chartered and supervised under Federal or State law. A deposit for the purposes of this provision is any deposit, withdrawable certificate, or withdrawable or repurchasable share of or in a qualified financial institution.

The amount of loss to be recognized in any year under the election is the difference between the taxpayer's basis in the deposit and the amount which is a reasonable estimate of the amount that will eventually be received with regard to such deposit.[32] A reasonable estimate of the amount that will eventually be received might, for example, be based on a determination by an agency having regulatory authority over the financial institution as to the percentage of total deposits that the institution (or its insurer) is likely to honor. If the recognized loss is later recovered, the taxpayer must include the amount thereof in income in the year of such recovery, under normally applicable tax benefit principles.

The election under this provision constitutes an election of a method of accounting with respect to all losses on deposits in the same institution, and may be revoked only with the consent of the Commissioner of Internal Revenue. If the election is made, no bad debt deduction is permitted under section 166.[33]

Interest on frozen deposits

The Act also provides that, in certain circumstances, interest earned by a qualified individual on a deposit in a qualified financial institution is not includible in the depositor's taxable income even though credited to the depositor's account.[34] Interest on a

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[31] It is anticipated that a technical amendment will be made permitting the taxpayer an alternative election to treat the loss as an ordinary loss under section 165(c)(2) of the Code. This election will be available only if no portion of the deposit is insured under Federal law, and the deduction will be limited in amount to $20,000 for any taxable year ($10,000 in the case of a separate return by a married individual) minus the amount of any insurance proceeds that can reasonably be expected to be received with respect to the deposit. Such an amendment was included in the versions of H. Con. Res. 395 which passed the House and the Senate in the 99th Congress.

[32] Although basis includes any interest credited to a depositor's account where such interest has been included in income, it does not include any interest on frozen deposits the recognition of which has been deferred under section 451(f) as added by the Act.

[33] The failure of a taxpayer to claim a loss under this provision in the year in which such loss can first be reasonably estimated will not preclude the taxpayer from claiming such loss in a later year, either under this election or as a bad debt under section 166.

[34] The terms "qualified individual" and "qualified financial institution" have the same meanings as under section 165(l), relating to the treatment of losses on deposits.

"frozen deposit" is includible in the depositor's income only to the extent the interest has been actually withdrawn during the calendar year or is subject to withdrawal (disregarding any penalties for premature withdrawal of time deposits). A frozen deposit is one not subject to withdrawal at the end of the calendar year because of the bankruptcy or insolvency (or threatened bankruptcy or insolvency) of the financial institution, or because of any requirement imposed by the State in which the institution is located by reason of the bankruptcy or insolvency of one or more financial institutions in the State.

Interest excluded under this provision is treated as credited to the depositor's account in the following calendar year, and is includible in that year (unless eligible under this provision for exclusion in that year). The Act also denies an interest deduction to the financial institution with respect to any interest on a frozen deposit excluded under this provision until such interest is includible in gross income.

Effective Date

The provision relating to losses on deposits is effective for taxable years beginning after December 31, 1982.[35] The provision relating to exclusion of interest on frozen deposits by a depositor generally applies to taxable years beginning after December 31, 1982. However, the latter provision applies to taxable years beginning after that date and before January 1, 1987, only if the taxpayer elects to have it apply to all such years. In addition, interest paid or incurred by a financial institution on a frozen deposit that is attributable to the period beginning January 1, 1983, and ending December 31, 1987, is not subject to the limitation on deductibility imposed by this provision.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $3 million in 1987, $1 million in 1988, $1 million in 1989, $1 million in 1990, and $1 million in 1991.

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[35] It is anticipated that a technical amendment will be made under which the provision will be effective for taxable years beginning after December 31, 1981. Such an amendment was included in the versions of H. Con. Res. 395 which passed the House and Senate in the 99th Congress.

TITLE X—INSURANCE PRODUCTS AND COMPANIES

A. Insurance Policyholders

1. Interest on installment payments of life insurance proceeds (sec. 1001 of the Act and sec. 101(d) of the Code)[1]

Prior Law

Under prior and present law, amounts paid by an insurance company to the beneficiary of a life insurance contract by reason of the death of an insured individual generally are not includible in gross income. Under certain life insurance contracts, the insurer may agree to hold the amounts that it would otherwise pay on the death of the insured and pay such proceeds of the contract at a later date.

If the insurer pays the insurance proceeds to a beneficiary in a series of payments after the death of the insured, a prorated amount of each payment is treated as a nontaxable payment of the death benefit, and the remainder of the payment generally is includible in gross income. Under prior law, the first $1,000 received by a surviving spouse in any taxable year in excess of the amount treated as a payment of the death benefit was excludable from gross income.

In addition, under prior and present law, the amount held by an insurer with respect to any beneficiary is the amount that equals the value of the agreement, provided in the life insurance contract, to make payments at a date or dates later than the death of the insured. The value of such an agreement was determined as of the date of death of the insured and was discounted on the basis of the interest rate and mortality tables used by the insurer in calculating payments under the agreement. Under prior law, the mortality tables used by an insurer for purposes of valuing the agreement described above could distinguish among individuals on the basis of sex.

Reasons for Change

The amount received by a beneficiary of a life insurance contract in excess of the prorated amount deemed to be a payment of the death benefit represents a payment made by the insurance company for the use of the beneficiary's money, i.e., the unpaid death benefit. Congress believed that this amount is comparable to interest paid by other financial institutions for the use of depositors' money and should be taxed in the same manner.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1001; H.Rep. 99-426, p. 657; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1001; S.Rep. 99-313, pp. 487-488; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 338-339 (Conference Report).

Congress was also concerned that, if gender-distinct mortality tables were used, the tax system distinguished among individuals on the basis of sex in calculating the amount of any payment that is deemed to be attributable to a death benefit. In most cases under the Internal Revenue Code, gender-neutral mortality tables are prescribed by the Secretary of the Treasury. Congress found it appropriate to direct the Secretary to prescribe a similar gender-neutral table for purposes of valuing the delayed payment of a death benefit.

Explanation of Provision

Under the Act, all amounts paid to any beneficiary of a life insurance policy at a date later than the death of the insured are included in the beneficiary's gross income to the extent that the amount paid exceeds the amount payable as a death benefit. The special exclusion from the gross income of a surviving spouse of the first $1,000 in excess of the amount payable as the death benefit is repealed.

The Act also requires, for purposes of valuing the portion of any payment deferred beyond the death of the insured that is a nontaxable death benefit, that an insurer use mortality tables prescribed by the Secretary of the Treasury in regulations. Congress expects that such tables will not distinguish among individuals on the basis of sex. An insurer is not permitted to use its own mortality table in determining the portion of any payment attributable to a nontaxable death benefit. As under prior law, the insurer is permitted to use its assumed interest rate in calculating payments under the agreement.

The operation of this rule does not prevent an insurance company from making payments to beneficiaries based on its own mortality tables. Rather, the provision operates to specify the portion of any installment payment that is to be treated as a payment of an excludable death benefit and the portion attributable to interest that is includible in gross income.

Effective Date

The provision applies to amounts received with respect to deaths occurring after October 22, 1986, in taxable years ending after that date.

2. Treatment of structured settlement agreements (sec. 1002 of the Act and sec. 130 of the Code)[2]

Prior Law

Prior and present law exclude from gross income the amount of any damages received on account of personal injuries or sickness, whether by suit or agreement and whether as a lump sum or as periodic payments (Code sec. 104(a)(2)). The person liable to pay the damages could assign to a third party (a structured settlement company) the obligation to make the periodic payments.

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[2] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1003; H.Rep. 99-426, p. 659; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1002; S.Rep. 99-313, pp. 488-490; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 339-340 (Conference Report).

Under prior and present law, the portion of the amount received by the structured settlement company agreeing to a "qualified assignment" that is used to purchase qualified funding assets to fund the liability is not included in the company's income. The basis of a qualified funding asset is reduced by the amount excluded from gross income on account of the purchase of the asset. On disposition of a qualified funding asset, the gain recognized is treated as ordinary income. However, periodic payments made by the structured settlement company to the injured party are deductible. The net effect of the use of a structured settlement agreement is to permit a taxpayer liable for damages to an injured party to deduct the amount of the damages as if they are paid in a lump sum and to permit a structured settlement company to exclude from income the earnings on amounts used to fund its liability to make periodic payments to the injured party.

Under prior law, a qualified assignment included all assignments requiring payments for personal injuries or sickness without regard to whether the payments involved physical injury or sickness.

Reasons for Change

The tax treatment of structured settlements has the overall effect of exempting from taxation investment income earned on assets used to fund the periodic payment of damages.[3] Congress believed that this effect is inappropriate where the injury did not involve physical injury or physical sickness. In cases involving personal nonphysical injuries, Congress concluded that the investment income earned on assets used to fund the damage payment should be subject to taxation, whether or not the damages are paid by means of a structured settlement arrangement.

Explanation of Provision

The Act limits "qualified assignments" to those assignments requiring the payment of damages on account of a claim for personal injuries that involve physical injury or physical sickness of the claimant. Thus, the exclusion for structured settlements applies only to those qualifying structured settlement arrangements for payments of damages on account of a claim for personal injuries that involve physical injury or physical sickness of the claimant, including damages on account of a claim for wrongful death arising from physical injury or sickness, provided the arrangements meet all other applicable requirements.

Claims which do not involve physical injury or physical sickness include, for example, defamation of a third party or invasion of privacy.

Congress understood that multiple claims are alleged in many personal injury actions. Congress did not intend that allocation of damages is necessary among such multiple claims. Rather, if the action has its origin in a physical injury, then all damages that flow therefrom are treated as payments involving physical injury or physical sickness.

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[3] By contrast, if a party liable for damage payments does not assign the liability in a structured settlement arrangement, then (1) income on amounts used to fund periodic payments of damages is subject to tax, and (2) investment income earned on lump-sum settlements is taxed to the recipient.

Effective Date

The provision is effective for assignments entered into after December 31, 1986, in taxable years beginning after December 31, 1986.

3. Life insurance policyholder loans (sec. 1003 of the Act and sec. 264 of the Code)[4]

Prior Law

Under prior and present law, no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry certain life insurance, endowment or annuity contracts pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of increases in the cash value of the contract, unless the requirements of certain exceptions to this disallowance rule are satisfied (sec. 264). The requirements of one of these exceptions (known as the four-out-of-seven rule) are that no part of four of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract is paid) is paid by means of debt. If the requirements of the four-out-of-seven rule are satisfied, the deduction is not disallowed under section 264.

In addition, no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment or annuity contract (sec. 264(a)(2)). Single premium contracts include contracts under which substantially all of the premiums are paid within 4 years from the date on which the contract is purchased, or contracts under which an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. Single premium contracts are not eligible for the four-out-of-seven rule.

Reasons for Change

Interest deduction

Generally, when a policyholder borrows against a life insurance policy, the loan reduces the death benefit by the amount of the borrowing. Congress was concerned that, in the case of business-owned life insurance on the life of an employee, much of the death benefit promised to an employee is illusory if the employer borrows against the policy. The employee is merely depending upon the credit of his employer to the extent of the indebtedness. Congress was also concerned that, unlike most commercial loans, there is no set repayment period for these policy loans. The loan may remain outstanding until the employee's death many years in the future, and the employer may never have any obligation to repay the loan. Thus, in order to encourage businesses to provide effective death benefits to employees, the Act provides that the deduction for interest on business-owned life insurance is limited to interest on life insurance related to loans aggregating no more than $50,000 per officer, employee or person financially interested in a business of the taxpayer.

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[4] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S8051 (June 20, 1986), and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 340-341 (Conference Report).

This provision provides a cap on the deductibility of such interest, rather than phasing out deductibility. The provision was structured in this manner to allow small businesses to use loans on life insurance policies for their employees as a source of short-term capital when necessary. Congress did not intend to allow these loans to be an unlimited tax shelter as under prior law.

Single premium policies

It had also come to the attention of Congress that some practitioners may have been taking the position that some single premium life insurance contracts were eligible for the "four out of seven" exception to the disallowance rule, or that interest on borrowing with respect to a single premium contract was deductible under prior law. Further, the Congress was concerned that some practitioners may have been characterizing a universal life insurance policy as a contract that provides for annual premiums due for purposes of the four out of seven rule. Congress believed it was appropriate to restate and clarify the provision of prior and present law disallowing interest deductions with respect to borrowings incurred or continued in connection with single premium life, endowment or annuity contracts.

Explanation of Provision

Interest deduction

In general, the provision limits the deductibility of interest paid or accrued on debt with respect to life insurance policies covering the life of an officer, employee or individual financially interested in any trade or business carried on by the taxpayer. The limitation applies to the extent the aggregate amount of such debt exceeds $50,000 per officer, employee or financially interested individual.

In the case of a taxpayer carrying on more than one trade or business, the $50,000 amount per officer, employee or person who is financially interested in any trade or business of the taxpayer is determined on an aggregate basis for each such person in all trades or businesses of the taxpayer. For example, if an employee of a business of the taxpayer is also an officer in two other businesses of the taxpayer, the $50,000 of permitted borrowings by the taxpayer with respect to life insurance covering the person is determined by aggregating all policies covering his life subject to this provision and with respect to which the taxpayer has borrowed. In the case of a controlled group of corporations, it is intended that the controlled group is considered to be one taxpayer for this purpose, and all loans with respect to policies covering the life of an officer or employee or person financially interested in, a business of any member of the group are aggregated. Similar principles are intended to apply in the event of common ownership of unincorporated trades or businesses.

Under the Act, the fact that the proceeds of a loan under a life insurance contract are used in a trade or business does not affect the deductibility of interest paid on the loan. Therefore, for example, if a sole proprietor borrows under a life insurance policy on the sole proprietor's life, the interest paid on the loan (to the extent the loan exceeds $50,000) is not deductible even though the proceeds of the loan are used in the sole proprietor's trade or business.

Single premium contracts

The Act restates the prior-law rule that no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract (sec. 264(a)(2)). Single premium contracts include contracts where substantially all of the premiums are paid within four years from the date on which the contract is purchased, or contracts where an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. Generally, section 264(a)(2) also applies to contracts other than those under which the nonpayment of premiums would cause the policy to lapse, but no inference is intended that universal life insurance policies are always treated as single premium contracts.

Effective Date

The provision is effective for interest on loans under policies purchased after June 20, 1986, in taxable years ending after that date. Applications for a policy of this sort are often sent after consideration of competing bids, and an application is usually considered to be acceptance of the insurance company's bid; under this provision, therefore, policies are considered purchased for purposes of the effective date once the policy has been applied for. Factual determinations under this provision will be made by the Internal Revenue Service and the courts. A life insurance contract, other than one received in exchange for a life insurance contract issued by the same insurer, received after June 20, 1986, in exchange for an existing contract is considered to have been purchased after June 20, 1986. In the case of a policy purchased before June 21, 1986, minor administrative changes in the policy after June 20, 1986, such as changes in the address of the insurer, the officers of the insurer, or the address of the insured, do not cause the policy to be treated as purchased after June 20, 1986.

4. Deduction for nonbusiness casualty losses (sec. 1004 of the Act and sec. 165(h) of the Code)[5]

Prior Law

Under prior and present law, for property not connected with a trade or business or a transaction entered into for profit, casualty losses are deductible only if they arise from "fire, storm, shipwreck, or other casualty or theft." These personal casualty losses were deductible under prior law only to the extent that each casualty loss exceeded $100, and to the extent that all casualty losses for the year exceeded 10 percent of the taxpayer's adjusted gross income (sec. 165(h)). Certain courts have ruled that a taxpayer whose loss was covered by an insurance policy could nevertheless deduct the loss if the taxpayer decided not to file a claim under the terms of the insurance policy. See *Hills* v. *Commissioner*, 691 F.2d 997 (11th Cir. 1982); *Miller* v. *Commissioner*, 733 F.2d 399 (6th Cir. 1984).

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[5] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1002; H.Rep. 99-426, p. 658; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 342-343 (Conference Report).

Reasons for Change

The deduction for personal casualty losses should be allowed only when a loss is attributable to damage to property that is caused by one of the specified types of casualties. If the taxpayer has the right to receive insurance proceeds that would compensate for the loss, the loss suffered by the taxpayer is not damage to property caused by the casualty. Rather, the loss results from the taxpayer's personal decision to forego making a claim against the insurance company. Congress concluded that losses resulting from a personal decision of the taxpayer should not be deductible as a casualty loss.

Explanation of Provision

Under the Act, a taxpayer is not permitted to deduct a casualty loss for damages to property not used in a trade or business or in a transaction entered into for profit unless the taxpayer files a timely insurance claim with respect to damage to that property. This requirement applies only to the extent any insurance policy would provide reimbursement for the loss. If a policy would provide compensation for the loss, it is immaterial whether the taxpayer is the primary beneficiary of the policy so long as it is within the control of the taxpayer whether to file a claim.

Effective Date

The provision applies to losses sustained in taxable years beginning after December 31, 1986.

Revenue Effect of Part A (Insurance Policyholders)

These provisions are estimated to increase fiscal year budget receipts by $2 million in 1987, $5 million in 1988, $6 million in 1989, $7 million in 1990, and $8 million in 1991.

B. Life Insurance Companies

1. Special life insurance company deduction (sec. 1011 of the Act and former sec. 806(a) of the Code)[6]

Prior Law

Under present and prior law, a life insurance company is taxed at corporate rates on its life insurance company taxable income (LICTI) and certain other income. Under prior law, a life insurance company was allowed a special deduction in computing LICTI equal to 20 percent of the income from insurance businesses that otherwise would be subject to taxation (sec. 806(a)).

Reasons for Change

The 20-percent special life insurance company deduction was enacted in 1984 because it was believed necessary to ameliorate the sudden, substantial increase in the tax liability of life insurance companies. This increase occurred as a result of the change from the three-phase taxable income computation that was in effect previously to a single-phase system consistent with generally applicable corporate tax law. The provision was not intended to tax life insurance companies at generally lower tax rates than other corporations.

In light of the overall reduction of corporate tax rates contained in other provisions of the Act, Congress concluded that the 20-percent special life insurance company deduction was no longer necessary. Despite the elimination of this special deduction, the maximum marginal tax rate applicable to life insurance companies will decline under the Act.

Explanation of Provision

Under the Act, the special life insurance company deduction is repealed. In addition, a special rule is provided in the case of a life insurance company owning the stock of another corporation through a partnership, which stock was acquired on January 14, 1981.

Effective Date

This provision is effective for taxable years beginning after December 31, 1986.

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[6] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1011; H. Rep. 99-426, p. 662; H.R. 3838, as reported by Senate Committee on Finance on May 29, 1986, sec. 1011; S. Rep. 99-313, pp. 491-492; and H. Rep. 99-841, Volume II (September 18, 1986), p. 344 (Conference Report).

2. Tax-exempt organizations engaged in insurance activities (sec. 1012 of the Act and sec. 501(m) of the Code)[7]

Prior Law

In general

Prior and present law (sec. 501(c)) specifies various standards that an organization must meet in order to qualify for exemption from Federal income taxation. These standards vary depending on the basis on which the entity is seeking exemption. Certain insurance activities performed by an organization may make it ineligible for tax exemption.

In addition, an organization that is otherwise exempt from Federal income tax generally is taxed on any income from a trade or business that is unrelated to the organization's exempt purposes. Specific exclusions from unrelated trade or business taxable income are provided for certain types of income, including rents, royalties, dividends, and interest, and certain other income, other than income derived from "debt-financed property."

Charitable organizations

An organization is exempt from Federal income tax if it is a corporation, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, educational, or certain other purposes (sec. 501(c)(3)). An organization is not considered organized or operated exclusively for one or more of the exempt purposes unless it serves a public rather than a private interest.[8]

Under prior law, the providing of insurance benefits by an organization otherwise described in sec. 501(c)(3) generally was considered a commercial activity that did not meet the requirements for tax-exempt status. For example, if two or more unrelated tax-exempt organizations pooled funds for the purpose of accumulating and holding funds to be used to satisfy malpractice claims against the organizations, the organization holding the pooled funds was not entitled to tax exemption because the activity (i.e., the provision of insurance) was inherently commercial in nature.[9]

Nevertheless, at least one major organization, which provides life insurance and annuities to employees of tax-exempt educational institutions, was recognized as a charitable organization by the IRS.

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[7] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1012; H. Rep. 99-426, pp. 662-666; and H. Rep. 99-841, Volume II (September 18, 1986), pp. 344-351 (Conference Report).

[8] Treas. Reg. sec. 1.501(c)(3)-1(d)(1).

[9] See, e.g., GCM 39122, CC:EE-36-82 (January 25, 1984); GCM 39003, CC:EE-37-82 (June 24, 1983).

Social welfare organizations

Under prior and present law, an organization is entitled to tax exemption if it is operated exclusively for the promotion of social welfare.[10] At least one major health insurance provider was treated as a tax-exempt social welfare organization under prior law. Other organizations providing insurance were denied tax-exempt status as social welfare organizations. For example, an insurance trust set up to provide group life insurance for members was held not to be tax-exempt because the trust was organized only for the benefit of its members, which was a limited class.[11] Further, if the benefit from an organization is limited to that organization's members, except for some minor and incidental benefit to the community as a whole, then, under prior and present law, the organization is not operated exclusively for the promotion of social welfare.[12]

Fraternal beneficiary societies

Under prior and present law, a fraternal beneficiary society, order, or association (sec. 501(c)(8)) is entitled to tax exemption if it operates under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and provides for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

Reasons for Change

Congress was concerned that exempt charitable and social welfare organizations that engage in insurance activities are engaged in an activity whose nature and scope is inherently commercial rather than charitable; hence, tax-exempt status is inappropriate. Congress believed that the tax-exempt status of organizations engaged in insurance activities provided an unfair competitive advantage to these organizations. Congress further believed that the provision of insurance at a price sufficient to cover the costs of insurance generally constitutes an activity that is commercial.

In addition, the availability of tax-exempt status under prior law allowed some large insurance entities to compete directly with commercial insurance companies. For example, Blue Cross/Blue Shield organizations historically had been treated as tax-exempt organizations described in sections 501(c)(3) or (4). Other tax-exempt charitable and social welfare organizations engaged in insurance activities also had a competitive advantage over commercial insurers who do not have tax-exempt status.

Congress was also concerned that some tax-exempt fraternal beneficiary societies described in section 501(c)(8) of the Code engage in large-scale insurance activities which may be inherently commercial in nature, and that such organizations may derive a competitive advantage from their tax-exempt status.

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[10] Sec. 501(c)(4).

[11] *N.Y. State Association of Real Estate Boards Insurance Fund* v. *Comm'r*, 54 TC 1325 (1970).

[12] Rev. Rul. 75-199, 1975-1 CB 160.

Explanation of Provision

Under the Act, an organization described in sections 501(c)(3) and (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. For this purpose, no substantial part has the meaning given to it under present law applicable to such organizations. See, e.g., *Haswell* v. *U.S.*, 500 F.2d 1133 (Ct. Cl. 1974); *Seasongood* v. *Comm'r*, 1227 F.2d 907 (6th Cir. 1955); see also sec. 501(h).

In the case of such a tax-exempt organization, the activity of providing commercial-type insurance is treated as an unrelated trade or business (sec. 513) but, in lieu of the usual tax on unrelated trade or business taxable income, the unrelated trade or business activity is taxed under the rules relating to insurance companies (Subchapter L).

For this purpose, commercial-type insurance generally is any insurance of a type provided by commercial insurance companies. The Act provides that the issuance of annuity contracts is treated as providing insurance. The activity of providing insurance or annuities under a qualified pension plan (described in sec. 401(a)) is an activity of providing commercial-type insurance, but is not affected by section 501(m) because such plans are not charitable or social welfare organizations to which the provision applies.

Several exceptions are provided to the definition of commercial-type insurance. Commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients. See, e.g., Rev. Rul. 71-529, 1971-2 C.B. 234 (relating to the meaning of substantially below cost). A class of charitable recipients refers to a group of recipients that would constitute a charitable class under present law. Commercial-type insurance also does not include health insurance provided by a health maintenance organization that is of a kind customarily provided by such organizations and is incidental to the organization's principal activity of providing health care.

The Act is not intended to alter the tax-exempt status of an ordinary health maintenance organization that provides health care to its members predominantly at its own facility through the use of health care professionals and other workers employed by the organization. HMOs provide physician services in a variety of practice settings primarily through physicians who are either employees or partners of the HMO or through contracts with individual physicians or one or more groups of physicians (organized on a group practice or individual practice basis). Similarly, organizations that provide supplemental health maintenance organization-type services (such as dental services) would not be affected if they operate in the same manner as a health maintenance organization.

Similarly, commercial-type insurance does not include arrangements that are not treated as insurance (i.e., in the absence of sufficient risk shifting and risk distribution for the arrangement to constitute insurance).[13] For example, if a hospital that is exempt from income tax under section 501(c)(3) establishes a trust to accumulate and hold funds for use in satisfying malpractice claims against the hospital, the arrangement does not constitute insurance and accordingly is not treated as providing commercial-type insurance.

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[13] See *Helvering v. LeGierse*, 312 U.S. 531 (1941). The Internal Revenue Service has ruled that risk shifting and risk distribution are necessary to a valid insurance transaction. See Rev. Rul. 77-316, 1977-2 C.B. 53, and Rev. Rul. 78-338, 1978-2 C.B. 107.

Under the Act, commercial-type insurance does not include property or casualty insurance provided directly or through an organization described in section 414(e)(3)(B)(ii) by a church or convention or association of churches for the church, convention or association. It also does not apply to the provision of retirement or welfare benefits by such organizations directly or indirectly through an organization described in section 414(e)(3)(A) or 414(e)(3)(B)(ii) for the employees of such organizations, or for employees' beneficiaries. This exception is not intended to apply if insurance is provided to persons other than the church or convention or association of churches and their employees.

With respect to fraternal beneficiary societies engaged in insurance activities, Congress reemphasizes the requirement of present and prior law that such tax-exempt organizations maintain an active lodge system. The Act also requires that the Treasury Department audit and study fraternal beneficiary organizations (described in sec. 501(c)(8)) that received gross insurance premiums in excess of $25,000,000 in taxable year 1984. Congress intends that the use of revenues from the insurance activities of such organizations be studied. The Treasury has authority under the Act to require the furnishing of information necessary to conduct the audit and study. The results of the study, together with recommendations, are to be submitted to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, and the Joint Committee on Taxation no later than January 1, 1988, so that Congress may consider the recommendations and take such action regarding the tax treatment of fraternal beneficiary societies engaged in insurance activities as is appropriate.

Certain health insurance providers

The Act provides the following treatment of existing Blue Cross or Blue Shield organizations and other organizations that meet certain requirements and substantially all of whose activities are providing health insurance. Health insurance includes insurance that provides coverage of medical expenses.

The Act provides that such existing Blue Cross and Blue Shield organizations and other organizations eligible for this treatment are subject to tax as stock property and casualty insurance companies under Part II of Subchapter L of the Code, as amended under the Act. Thus, such organizations are generally subject to the provisions applicable to property and casualty insurance companies in the Act, except as otherwise provided.

Certain treatment (described in more detail below) applies to Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) are determined at any time to be tax exempt under a determination that has not been revoked;[14] and (3) were tax exempt for the last taxable year beginning before January 1, 1987, provided that no material change occurs in the structure or operations of the organization after August 16, 1986, and before the close of 1986 or any subsequent taxable year. Congress intends that the following principles will be applied by the Secretary in determining whether or not a material change in operations or structure has occurred.

Material change in operations or structure

First, the merger or split up of 1 or more existing Blue Cross/Blue Shield organizations, or the conversion to a mutual company status under local law, will not constitute a material change in operation or structure.

Second, if an existing Blue Cross/Blue Shield organization acquires a new line of business or is acquired by another business (other than a health business), the acquisition does not, by itself, constitute a material change in operations or structure of the organization if (1) the assets of the other business are a de minimis percentage (i.e., less than 10 percent) of the assets of the existing Blue Cross/Blue Shield organization at the time of the acquisition, or (2) the taxpayer can demonstrate to the Secretary of the Treasury that, based on all the facts and circumstances, the acquisition does not constitute a material change in operations or structure of the existing Blue Cross/Blue Shield organization.

Third, a material change in operations occurs if an existing Blue Cross/Blue Shield organization drops its high risk coverage or substantially changes the terms and conditions under which high risk coverage is offered by the organization from the terms and conditions in effect as of August 16, 1986. A change in high risk coverage is considered substantial if the effect of the change is to defeat the purpose of high risk coverage. High risk coverage for this purpose generally means the coverage of individuals and small groups to the extent the organization (1) provides such coverage under specified terms and conditions as of August 16, 1986, or (2) meets the statutory minimum definition of high risk coverage for new organizations. A material change in operations does not occur if an existing organization alters its operations to provide high risk coverage that meets the minimum standards under the Act for new Blue Cross/Blue Shield organizations.

For example, if an existing Blue Cross/Blue Shield organization provides open enrollment to all individuals and small groups of less than 5 individuals, the organization could redefine a small group for purposes of this coverage to mean the lesser of 15 individuals or the minimum number of individuals required for a small group under State law. Such a redefinition of a small group (from 5 to 15 individuals) would not be considered a material change in operations because the organization would meet the minimum standard for a new organization with respect to small group coverage.

A material change in operations occurs if the effect is to eliminate coverage for a significant high-risk segment of the plan's business. Whether a change in operations constitutes a material change in operations depends on all of the facts and circumstances.

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[14] Congress intends that, to the extent such determinations of tax exemption for any taxable year beginning before 1987 were not under audit or in litigation before August 16, 1986, the Internal Revenue Service will not seek to revoke such determinations.

A material change is presumed to occur if an organization, on or after August 16, 1986, ceases to offer coverage for individuals or small groups or conversion coverage for those individuals who leave an employment-based group because of termination of employment. A material change generally occurs if an organization, which on August 16, 1986, offered individual coverage that allowed enrollment regardless of medical condition, modifies enrollment practices for that coverage to exclude certain individuals because of a preexisting medical problem.

A material change in operations does not occur if the plan increases its premium rates to reflect increases in health care costs or makes normal changes in products or services to respond to changes and developments generally in the health care environment. Thus, this material change in operations rule is not intended to prevent a plan from making normal adjustments in their business practices, such as adjustments to reflect new trends in cost containment or adding new coverages.

Any change in business practice that either eliminates coverage of high-risk individuals or small groups or that has the effect of eliminating such coverage, however, is a material change in structure or operation. For example, a premium increase that reflects normal increases in medical costs is not itself treated as a material change. On the other hand, a premium increase that has the effect of making high-risk coverage unavailable because of the cost of such coverage is treated as a material change.

Similarly, a material change generally will occur if an organization after August 16, 1986, ceases offering individual or small group coverage in a defined geographic area due to a concentration of high risk individuals in that area. In addition, a material change generally will occur if an organization institutes, subsequent to August 16, 1986, a procedure to identify particular individuals within the pool of individual enrollment, reassess their individual risk due to excessive utilization, and cancel their coverage.

The material change rule is not intended to prevent existing Blue Cross and Blue Shield organizations from changing their high risk coverage to respond better to the needs of that population. For example, a material change would not occur if the organization introduced a preferred provider arrangement or a managed care product for individual high risk coverage that included financial incentives or requirements to use more cost effective providers or benefits (*e.g.*, home health or hospice care rather than hospitalization). The material change rule also is not intended to prevent existing Blue Cross and Blue Shield organizations from establishing special coverages that recognize health lifestyles. For example, a material change would not occur if smokers were charged a higher premium than non-smokers.

Special deduction

A special deduction is provided to such organizations with respect to their health business equal to 25 percent of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year. This deduction is calculated by computing surplus, taxable income, claims incurred, expenses incurred, tax-exempt income, net operating loss carryovers, etc., attributable to health business. Claims incurred also include claims under cost-plus contracts. Thus, the deduction is not allowable with respect to such items attributable to, for example, life insurance business. The expenses attributable to health business are those incurred during the taxable year in connection with the administration, adjustment or settlement of claims under health business. The deduction may not exceed taxable income attributable to health business for the year (calculated without regard to this deduction).

For organizations eligible for this deduction in the first taxable year beginning after December 31, 1986, the amount of the adjusted surplus to be applied in the first year for which the deduction is allowable is the surplus reported on the organization's annual statement (i.e., the annual statement approved by the National Association of Insurance Commissioners) at the close of the preceding year, adjusted by not taking into account distributions (such as distributions to shareholders, or contributions or loans to affiliates that reduce surplus, but not including ordinary and necessary expenses or deductible policyholder dividends) after the date of conference action (August 16, 1986). For organizations that first become eligible for the provision in a later taxable year, the amount of the adjusted surplus for the first year of the deduction is the surplus reported on the annual statement at the close of the preceding year.

The initial surplus amount is adjusted under the provision at the close of each taxable year by adding the taxable income or loss[15] of the organization for the year (determined without regard to net operating loss carryovers and without regard to the deduction under this provision), plus net tax-exempt income for the year. Net tax-exempt income means dividends to the extent a dividends received deduction was allowed, and interest that is tax-exempt, less the expenses of earning the tax-exempt interest that were disallowed under sec. 265, and less the adjustment that was made for proration of tax-exempt income under sec. 805(a) or sec. 832(b)(5) (as amended by the Act). If an organization eligible for the deduction under this provision does not take the deduction in any year, adjusted surplus must be calculated for the intervening years between the last year the organization took the deduction and the next year in which it takes the deduction, so as to take account properly of the calculation of the deduction in the later year.

For example, assume a calendar year Blue Cross organization engaged only in health business, the State law surplus (as adjusted) of which was $100 million on January 1, 1987. In 1987, the organization has health claims and expenses incurred of $880 million and adjusted taxable income of $160 million (including net tax-exempt income of $10 million). In 1987, the organization would be entitled to a special deduction of $120 million, that is, the excess of $220 million (25 percent of the 1987 claims and expenses paid) over $100 million (the 1987 opening surplus).

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[15] As under present and prior law, insurance loss reserves must be reasonable (see title X; part C.1., below). Generally, it is intended that the loss reserves of organizations eligible for the deduction under this provision also be reasonable, and that they be comparable to the historical loss reserves of the organization in relation to its claims and expenses.

As a further example, assume that in 1988, the organization has health claims and expenses incurred of $1.2 billion. Its special deduction for 1988 would be $40 million, that is, the excess of $300 million (25 percent of the 1988 health claims and expenses incurred) over the opening 1988 adjusted surplus balance of $260 million. The opening 1988 surplus is calculated by taking the sum of (a) 1987 opening surplus of $100 million, plus (b) 1987 adjusted taxable income of $160 million (including 1987 net tax-exempt income of $10 million).

The deduction applies only for regular tax purposes. Therefore, the deduction is treated as a preference item for purposes of the corporate minimum tax.

Accounting method

In addition to this special deduction, such organizations are given a fresh start with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. No adjustment is made under section 481 on account of an accounting method change.

Existing Blue Cross/Blue Shield organizations are required to compute their ending 1986 loss reserves without artificial changes that would reduce 1987 income. This rule as to reserve weakening is to be applied so that the incurred-but-not-paid claims reserve at the end of 1986 will be redetermined using actual paid claims data for 1987. That amount will be used for purposes of determining both the surplus at December 31, 1986, and the opening loss reserve at January 1, 1987. Use of actual experience to determine those amounts will eliminate potential controversy over the proper amount of the surpluses and reserves for 1987 tax purposes. The loss reserve then will be adjusted, as appropriate, by the rules of section 1023 of the Act requiring the discounting of unpaid losses.

Unearned premium reserves

Such organizations are not subject to the treatment of unearned premium reserves generally applicable to property and casualty insurance companies under the Act. Congress determined that during the period such organizations were tax exempt, any mismatching of currently deductible premium acquisition expenses and deferred premiums (resulting from the unearned premium reserve deduction) had no significant tax impact, and therefore it is not appropriate to require these organizations to include in income a portion of the outstanding balance of the unearned premium reserve. To ease the transition from tax-exempt to taxable status, Congress determined that it is appropriate to give such organizations relief from the requirement that 20 percent of the increase in unearned premium reserves be included in income.

Basis of assets

Finally, the basis of assets of such organizations is equal, for purposes of determining gain or loss, to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986. Thus, for formerly tax-exempt organizations utilizing a calendar period of accounting and whose first taxable year commences January 1, 1987, the basis of each asset of such organization is equal to the amount of its fair market value on January 1, 1987. The basis adjustment is provided solely for purposes of determining gain or loss upon sale or exchange of the assets, not for purposes of determining amounts of depreciation or for other purposes. The basis adjustment is provided because Congress concluded that such formerly tax-exempt organizations should not be taxed on unrealized appreciation or depreciation that accrued during the period the organization was not generally subject to income taxation.

The foregoing special provisions apply to existing tax-exempt Blue Cross and Blue Shield organizations and to those other organizations that satisfy the additional criteria described below.

Other organizations

Other organizations substantially all of whose activities are providing health insurance, in order to receive the treatment under the provisions described above, must meet certain requirements.

First, at least 10 percent of the health insurance (determined as a percentage of the total number of individuals covered annually) provided by the organization must be provided to individuals and small groups (disregarding Medicare supplemental coverage). A small group is defined as the lesser of 15 individuals or the number of individuals required for a small group under the State law where the covered groups are located.

Second, the organization is required to provide continuous full-year open enrollment for individuals and small groups. Open enrollment is intended to include conversions from group to individual coverage (for example, upon separation from service with an employer who provides group coverage), without a lapse in coverage, provided the individual seeking to convert from group to individual coverage notifies the organization providing group coverage of his conversion request by the date of his separation from service. Conversion includes any change in the type of coverage (e.g., from one type of group to another).

Third, any individual seeking health insurance is required to be offered coverage which includes coverage of pre-existing conditions, and the coverage becomes effective within a reasonable waiting period after the time such coverage is sought. A reasonable waiting period is intended to be not more than three months. Further, health insurance coverage must be provided without regard to the age, income, or employment status of persons under age 65.

Fourth, at least 35 percent of the organization's health insurance premiums are determined on a community-rated basis. This percentage is determined as a percentage of the total number of persons covered on an annual basis. Community rating means that premiums are determined on the basis of the average annual cost of health insurance over the population in the community.

Fifth, the organization must be organized and operated in a manner such that no part of the net earnings inures to the benefit of any private shareholder or individual.

Effective Dates

The provision is effective for taxable years beginning after December 31, 1986. Special rules for Mutual of America and for Teachers Insurance Annuity Association-College Retirement Equities Fund provide that this provision does not apply with respect to that portion of their business attributable to pension business. For this purpose, the Act provides that pension business means the administration of qualified pension plans (sec. 401(a) or 403(a)), tax-sheltered annuities (sec. 403(b)), unfunded deferred compensation plans of State and local governments (sec. 457), and individual retirement arrangements (IRAs).

Additional special rules provide that this provision does not apply to the YMCA retirement fund, to administrative services performed by tax-exempt municipal leagues, and to the Missouri Hospital Plan.[16] No inference is intended, under this provision, as to whether the performance of administrative services by tax-exempt municipal leagues, without more, constitutes commercial-type insurance activities. Generally, however, the performance of administrative services with respect to insurance contracts by tax-exempt organizations may be subject to unrelated business tax.

An exception is also provided for dental benefit coverage by Delta Dental Plans organizations that are members of the Delta Dental Plans Association through contracts with independent service providers so long as the provision of such coverage is the principal activity of such Association.[17]

3. Operations loss deduction of insolvent companies (sec. 1013 of the Act)[18]

Prior Law

Prior to 1984, life insurance companies were permitted to exclude from taxable income 50 percent of the excess of gain from operations over taxable investment income. In addition, life insurance companies were allowed certain special deductions for nonparticipating contracts and for accident and health insurance and group life insurance contracts. The amounts deducted under these provisions were added to a deferred tax account known as the policyholders surplus account (PSA). The allowance of these special deductions, and the establishment of a PSA, were intended to provide a cushion of assets to protect the interests of the policyholders. The 1984 Act repealed the deduction for additions to a PSA, but continued the deferral on existing amounts in a PSA.

The deferral of tax on existing amounts held in the PSA of a life insurance company is ended if the amounts are distributed to shareholders. In certain circumstances, amounts may be required to be distributed from the PSA (i.e., the deferral of tax on such amounts is ended) if the PSA becomes too large in relation to the scope of the company's current operations. The deferral of tax on amounts in the PSA also may end if the company ceases to be taxed as a life insurance company. The amounts included in income as a result of ending deferral on amounts in the PSA cannot be offset by the company's loss from operations or loss carryovers.

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[16] A technical correction (with respect to the name of the Missouri Hospital Plan) may be needed so that the statute reflects this intent.

[17] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H.Con. Res. 395 which passed the House and Senate in the 99th Congress.

[18] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1013; H. Rep. 99-426, pp. 666-667; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1012; S. Rep. 99-313, pp. 492-493; and H. Rep. 99-841, Volume II (September 18, 1986), pp. 351-352 (Conference Report).

Reasons for Change

Congress determined that, in the limited case of a contraction of an insurance company's business due to insolvency on November 15, 1985, and the court-ordered liquidation of the company, it is appropriate to permit the otherwise unusable loss from operations or operations loss carryovers to offset the previously deferred amounts in the PSA. Congress concluded that this exception should be limited to this specific case in order to ensure that the tax otherwise due on a distribution from a PSA is collected.

Explanation of Provision

Under the Act, a life insurance company is permitted to apply its current loss from operations and its unused operations loss carryovers against the increase in its taxable income attributable to the amount distributed from its PSA if certain conditions are satisfied. First, the company must have been insolvent on November 15, 1985. Second, the company must be liquidated pursuant to the order of a court of competent jurisdiction in a title 11 or similar case. Third, as a result of the liquidation, the company's tax liability must be increased due to distributions from the PSA. Under the provision, no carryover of any loss from operations of the company arising during or prior to the year of liquidation may be used in any taxable year succeeding the liquidation year (regardless of whether the amount of the loss exceeds the amount of the distribution from the PSA).

Effective Date

The provision applies to liquidations on or after November 15, 1985.

Revenue Effect of Part B (Life Insurance Companies)

The provisions of Part B are estimated to increase fiscal year budget receipts by $430 million in 1987, $787 million in 1988, $857 million in 1989, $919 million in 1990, and $959 million in 1991.

C. Property and Casualty Insurance Company Taxation

1. Inclusion in income of 20 percent of unearned premium reserve (sec. 1021 of the Act and sec. 832(b) of the Code)[19]

Prior Law

Under prior and present law, the income of a property and casualty insurance company (whether stock or mutual)[20] includes its underwriting income or loss and its investment income or loss, as well as gains and other income items.[21] Under prior law, underwriting income meant premiums earned on insurance contracts during the year, less losses incurred and expenses incurred (sec. 832(b)(3)). To determine premiums earned, the increase in unearned premiums during the year (as reported as an increase in the unearned premium reserve on the annual statement approved by the National Association of Insurance Commissioners) was deducted from gross premiums (sec. 832(b)(4)(B)). This treatment of unearned premiums generally reflected accounting conventions imposed under applicable law.[22]

Unearned premiums of a property and casualty insurance company include its life insurance reserves (including annuity reserves), if any. Generally, the deduction for increases in the reserve for unearned premiums gave rise under prior law to a deferral of the premium income attributable to insurance coverage to be provided in a future taxable year of a property and casualty company.

Under prior and present law, property and casualty insurers can also deduct expenses incurred during the taxable year. Expenses incurred generally mean expenses shown on the annual statement. Expenses incurred are calculated by adding to expenses paid during the year the difference between unpaid expenses at the end of the current year and unpaid expenses at the end of the preceding year. Expenses incurred ordinarily include premium acquisition expenses, including the premium acquisition expenses attributable to unearned premiums. Expenses, to be deductible, must constitute ordinary and necessary trade or business expenses within the meaning of section 162, although this rule does not determine the time when the deduction is allowed.

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[19] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1021; H.Rep. 99-426, pp. 668-670; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1021; S.Rep. 99-313, pp. 495-498; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 354-355 (Conference Report).

[20] The use of the term "property and casualty insurance company" is intended to refer to all those taxpayers subject to tax under Part II or III of subchapter L of the Code prior to amendment by the Act, or Part II of subchapter L as amended by the Act.

[21] Under prior law, mutual companies with certain gross receipts less than $150,000 were exempt from tax (sec. 501(c)(15)), and other rules set forth special rates, deductions, and exemptions for mutual companies with certain categories and amounts of income (sec. 821 et seq.). In addition, mutual companies were allowed a special deduction for additions to a bookkeeping protection against loss account (sec. 824). (See the separate discussion of the protection against loss account, below.)

[22] See National Association of Insurance Commissioners ("NAIC")-approved annual statement form (often called the yellow blank) used by property and casualty insurance companies for financial reporting. The accounting techniques used in preparing this annual statement are referred to as statutory accounting principles (SAP), and generally are more conservative than generally accepted accounting principles (GAAP) and the cash and accrual methods of tax accounting.

Reasons for Change

Prior law permitted a deferral of unearned premium income, while the expenses of earning the deferred income (e.g., premium acquisition expenses) were deducted currently. Permitting a deferral of an undiscounted portion of unearned premium income while allowing a current deduction for associated costs of earning the deferred income produced a mismatching of income and expenses, and a resulting mismeasurement of income. Congress concluded that it was necessary to provide a better matching of income and expenses by reducing the current deduction for unearned premiums. This approach is equivalent to denying current deductibility for a portion of the premium acquisition expenses.

Explanation of Provision

General rule

Under the Act, a property and casualty insurance company generally is required to reduce its deduction for increases in unearned premiums by 20 percent. This amount is intended to represent the allocable portion of expenses incurred in generating the unearned premiums. Thus, for taxable years beginning after 1986, only 80 percent of the increase in unearned premiums in each year is deductible. To the extent there is a decrease in the unearned premium reserve for a taxable year beginning after 1986, the resulting inclusion in income of the decrease would be reduced; only 80 percent of the amount would be includible. Thus, if the taxpayer's unearned premium reserve increased in 1987 from $1,000 to $1,100, the net deduction for unearned premiums would be $80 ($1,100-1,000 x 80%). Similarly, if the unearned premium reserve declined in 1988 from $1,100 to $900, the taxpayer would be required to include $160, rather than $200, in income.

Life insurance reserves, as defined in section 816(b), that are included in unearned premium reserves under section 832(b)(4) are not subject to this reduction under the Act. Increases (or decreases) in such life insurance reserves remain deductible (or, to the extent a decrease in unearned premium reserves is attributable to a decrease in life insurance reserves, includible in income) as under prior law. This exception to the 80 percent rule is provided because such life insurance reserves are calculated under the life insurance company tax rules (sec. 807) in a manner intended to reduce the mismeasurement of income resulting from the mismatching of income and expenses.

Reciprocal insurers.—In the case of an interinsurer or reciprocal underwriter (within the meaning of sec. 835 of the Code) that is required under applicable State law to reduce the unearned premium reserve by applicable premium acquisition expenses, the amount of the unearned premium reserve is to be increased (before application of this provision) by the amount of such expenses to the extent that the amount of such expenses can be clearly ascertained from the face of the annual statement filed by the reciprocal or interinsurer.[23] The reason for this grossing up of the unearned premium reserve is that, without it, the annual increase in the unearned premium reserve, although already net of such expenses as reported on the annual statement, would again be reduced by an amount (20 percent) considered under this provision to represent the expenses allocable to the unearned premiums.

Application of general rule to outstanding balances

The Act also provides for the inclusion in income of 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987. This income is includible ratably over a six-year period commencing with the first taxable year beginning after December 31, 1986. In each of the first six taxable years during this period, 3⅓ percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987, is included in income.

Special rule

In the case of insurance against default in the payment of principal or interest on securities with a maturity of 5 years or more, the deduction for increases in unearned premiums is reduced by 10 percent, rather than 20 percent. Thus, only 90 percent of the increase in unearned premiums is deductible and 90 percent of any decrease is includible in income. Similarly, 10 percent of the outstanding balance of unearned premiums at the end of the most recent taxable year beginning before January 1, 1987, is included in income. This income is includible ratably over a 6-year period commencing with the first taxable year beginning after December 31, 1986.

Insurance on securities with a maturity of less than 5 years is subject to the general rule reducing the deduction (or inclusion) for a change in unearned premiums by 20 percent, and including 20 percent of the outstanding balance at the end of the first taxable year beginning before January 1, 1987.

Companies that cease to be insurance companies

Under the Act, if a property and casualty insurance company ceases to be subject to part II of subchapter L as amended by the Act (the rules relating to the treatment of unearned premiums), the rule for outstanding unearned premium balances as of the end of the last taxable year beginning before January 1, 1987, is applied to include the remaining amount subject to the rule in income for the taxable year preceding the taxable year in which the company ceases to be subject to tax as a property and casualty insurance company. This rule applies only if a company ceases to be a property and casualty company for a taxable year beginning before January 1, 1993. The rule does not apply to the extent a successor company (which is also a property and casualty insurance company) is subject to the requirements of sec. 381(c)(22).

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[23] A technical correction may be needed so that the statute reflects this intent.

For example, if a property and casualty insurance company has an outstanding unearned premium balance of $100 for its taxable year ending December 31, 1986, 20 percent of the unearned premium balance, or $20, is subject to the ratable inclusion rule. For its taxable year ending December 31, 1987, 3⅓ percent of $100, or $3.33, is included in income. If the company ceases to be a property and casualty insurance company for its taxable year beginning January 1, 1989, then $16.67 (the difference between the amount to be included ($20) and the amount previously included ($3.33)) is includible in income for the company's taxable year ending December 31, 1988.

Congress adopted this rule because the treatment of the outstanding unearned premium balance is designed to avoid a substantial income inclusion in the first taxable year after the effective date. However, if a company ceases to be a property and casualty insurance company during the phase-in period, Congress believed that the phase-in should be accelerated to prevent permanent avoidance of the income inclusion.

Treatment of small companies

The 20-percent inclusion rule may be applied over a different 6-year period, in the case of a company that (1) is exempt from tax under section 501(c)(15) in a taxable year beginning after 1986, and (2) becomes subject to tax under section 831(a) in a taxable year beginning after 1986, and (3) computed taxable income for a year beginning before 1987 taking into account a reserve for the gross amount of unearned premiums. In such a case, 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987, is to be included in income ratably over the six-year period that begins with the first taxable year in which the company is subject to tax under section 831(a).[24] In addition, if a company to which the requirement of inclusion in income of a portion of the unearned premium reserve elects to be taxed only on investment income in a taxable year beginning after 1986 and before 1993, then it is not intended that the rule that applies when a company ceases to be taxed as a property and casualty company apply. Rather, it is intended that the amount includible under this provision continue to be includible over the applicable 6-year period. If such a company subsequently becomes subject to tax under section 831(a), it is not intended that the company again become subject to the 6-year inclusion provision.

Effective Date

The provision is generally effective for taxable years beginning after December 31, 1986. The inclusion in income of 20 percent or 10 percent of unearned premium reserves outstanding for the most recent taxable year beginning before January 1, 1987, takes effect ratably over the 6 taxable years beginning after December 31, 1986, and before January 1, 1993.

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[24] A technical correction may be needed so that the statute reflects this intent.

The Act provides special treatment of title insurance unearned premium reserves (see item 3, below).

2. Treatment of certain dividends and tax-exempt interest (sec. 1022 of the Act and sec. 832(b)(5) of the Code)[25]

Prior Law

Under prior and present law, property and casualty companies are generally subject to tax on underwriting income (sec. 832(b)(1) and (3)). Under prior law, in calculating underwriting income, losses incurred (as well as expenses incurred) were deducted from premiums earned. The deduction for losses incurred generally reflected losses paid during the year as well as the increase in reserves for losses incurred but not paid.

Property and casualty insurance companies are also subject to tax on investment income, which generally includes interest, dividends and rents (sec. 832(b)(2)). A property and casualty insurer that includes in its investment income interest exempt from tax (sec. 103) may deduct this interest (sec. 832(c)(7)). Thus, in effect, the section 103 exclusion is available for eligible investment income. In addition, property and casualty companies are allowed the dividends received deduction (sec. 832(c)(12)).

No reduction in the loss reserve deduction was required, under prior law, to take account of the fact that deductible additions to reserves could come out of income not subject to tax. Unlike life insurance companies, property and casualty insurance companies were not required to allocate or prorate investment income (including tax-exempt investment income) so as to take account of the possibility of a double deduction where deductible additions to reserves were funded with tax-exempt income (or with the deductible portion of dividends received). In the case of life insurance companies, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the prorated policyholders' share of tax-exempt interest (sec. 812).[26] This life insurance tax rule is based on the assumption that reserve increases are being funded out of both taxable and tax-exempt income.

Reasons for Change

Congress believed that it was not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax. The amount of the addition to reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends.

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[25] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1022; H.Rep. 99-426, pp. 670-672; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 356-357 (Conference Report).

[26] Also, the dividends received deduction is reduced by the policyholders' share of the dividends (sec. 805(a)(4)).

Explanation of Provision

Under the Act, the deduction for losses incurred is reduced by 15 percent of (1) the insurer's tax-exempt interest and (2) the deductible portion of dividends received (with special rules for dividends from affiliates). For this purpose, tax-exempt interest includes interest income excludable under section 103 (or deductible under sec. 832(c)(7)), the portion of interest income excludable under section 133, and other similar items. If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in income.

In the case of dividends from affiliates that are 100 percent deductible,[27] the portion which is subject to proration in the hands of the parent property and casualty company is that portion of the dividend which is attributable to tax-exempt interest or non-affiliate dividends (that is, those dividends which would not be eligible for the 100 percent dividends received deduction of the subsidiary). Under the Act, for purposes of the proration rule, dividends are treated as paid first out of current or accumulated earnings and profits attributable to prorated amounts, that is, dividends are treated as paid first out of tax-exempt income of the paying company.

Special rules for dividends from insurance affiliates (whether life or property and casualty) provide that the amount of the reduction in the deduction for losses incurred as a result of proration in the hands of the recipient property and casualty company is offset by the effect of proration as applied to the affiliate. The special rules for proration of dividends from insurance affiliates are similar to rules applicable, under the technical corrections portion of this Act, to the treatment of dividends received by life insurance companies from other life insurance companies.

This provision may be illustrated as follows. Assume that, in 1987, a property and casualty insurer has tax-exempt interest of $1,000 and receives a dividend of $100 that is eligible for the 80 percent dividends received deduction. In addition, the company receives from an affiliate a dividend of $400 (none of which is attributable to amounts subject to proration) that is eligible for the 100 percent dividends received deduction. Under this provision, the deduction of losses incurred would be reduced by $162 (i.e., 15 percent of $1,000 plus 15 percent of $80 (the portion of the $100 dividend which is deductible).

The proration rule does not apply to tax-exempt interest and the deductible portion of dividends received or accrued on stock or obligations acquired before August 8, 1986. Stock or obligations acquired after August 7, 1986, are, for this purpose, treated as acquired on the actual acquisition date, regardless of the holding period of the property determined under section 1223. For example, the transfer of tax-exempt bonds among affiliates after August 7, 1986, is treated as an acquisition of the bonds after August 7, 1986.

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[27] 100 percent deductible dividends include any dividend if the percentage used for purposes of determining the deduction allowable under sec. 243, 244, or 245(b) is 100 percent. Under the Act, such dividends also include a dividend received by a foreign corporation from a domestic corporation which would be a 100 percent dividend if sec. 1504(b)(3) did not apply for purposes of applying sec. 243(b)(5).

In the case of dividends from affiliates, special rules apply to determine the date of acquisition. The portion of dividends received from an affiliate attributable to stock or obligations (the interest on which is tax-exempt) acquired by the affiliate after August 7, 1986, is subject to the proration rule. Further, if an affiliate is acquired after August 7, 1986, each share of stock or obligation (the interest on which is tax-exempt) held by the affiliate (or by its subsidiaries that are affiliates), whenever acquired by the affiliate, is treated, for purposes of applying the proration rule to dividends from the affiliate, as acquired after August 7, 1986. However, 100 percent dividends not attributable to prorated amounts (e.g., tax-exempt interest) will not be prorated even if the affiliate payor was acquired after August 7, 1986.

Effective Date

The provision relating to proration of tax-exempt interest and the deductible portion of dividends received (sec. 1022 of the Act) is effective for taxable years beginning after December 31, 1986.

3. Loss reserves (sec. 1023 of the Act and secs. 807, 832, and new sec. 846 of the Code) [28]

Prior Law

In general

Under prior and present law, property and casualty companies are required to include their underwriting and investment income or loss in taxable income (sec. 832(b)). Among the items that are deductible in calculating underwriting income are additions to reserves for losses and expenses incurred. Losses incurred include unpaid losses, the amounts of contested liabilities, and amounts which are estimated (and which therefore could be subject to future change when the amounts could be determined with reasonable accuracy).

The amount of the deduction for losses incurred is required to be reasonable. *See* Reg. sec. 1.832-4(b) and *Hanover Insurance Co. v. Commissioner*, 598 F.2d 1121 (1st Cir. 1979), *cert. denied*, 444 U.S. 915 (1979). Thus, under prior and present law, the Internal Revenue Service may review, and, if appropriate, adjust the amount of the deduction for unpaid losses and unpaid loss adjustment expenses.

Title insurance

Under prior law, the treatment of title insurance (i.e., insurance to protect the buyer of real property against the risk that a defect in the title or an encumbrance against the property exists at the time the property was purchased) was unclear. Under Rev. Rul. 83-174, 1983-2 C.B. 108, as modified by Rev. Rul. 84-107, 1984-2 C.B. 122, for title insurers operating in jurisdictions requiring the maintenance of an unearned premium reserve, the IRS had permitted premiums received by title insurers (to the extent of the reserve required under State law) to be treated as unearned premiums for Federal income tax purposes for years beginning before November 28, 1984; however, the taxpayer could not deduct incurred but unreported losses in addition to unearned premiums for tax years beginning on or after November 28, 1983.

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[28] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1023; S.Rep. 99-313, pp. 498-510; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 357-367 (Conference Report).

Reasons for Change

The loss reserves taken into account under prior law for tax purposes, and for State regulatory reporting on the annual statement prescribed by the National Association of Insurance Commissioners ("NAIC"), were determined for the most part as the arithmetic sum of anticipated claims payments in future years. Congress concluded that prior law did not accurately measure the income of property and casualty insurers. Unlike other taxpayers, property and casualty insurance companies were permitted to deduct losses prior to the time the loss was paid or accrued. Congress determined that the prior-law treatment of property and casualty companies thereby permitted such companies to overstate the true current cost of the insured loss; the deduction for such losses was overstated by the amount by which the nominal dollar value of a loss exceeded the present value of the insurance company's liability to pay the resulting claim. The longer the period of time involved, the greater the overstatement. In other words, the failure of prior law to reflect the time value of money permitted these companies to understate their income.

Congress recognized that the nature of the business of a property and casualty company affected the extent to which loss deductions are overstated. For example, some types of policies (such as medical malpractice or commercial liability policies) typically give rise to a long deferral period between occurrence of a loss and payment of a claim. These "long-tailed" losses received the greatest benefit from the failure to take into account the time value of money. Congress determined that the tax treatment of loss reserve deductions has contributed to what is referred to as cash flow underwriting, in which a property and casualty company established a premium based on the assumption that investment income (which often is tax exempt) will offset underwriting losses.

Congress concluded that it was necessary to undertake a comprehensive restructuring of the tax treatment of loss reserve deductions for property and casualty insurance companies. The Act modifies the timing and amount of loss reserve deductions to take account partially of the time value of money available currently under the property and casualty taxation provisions.

The Act adopts a pre-tax method of discounting similar to a method proposed by the General Accounting Office to reduce the loss reserve deductions of property and casualty companies. This method of discounting is dissimilar to the rules applicable to other taxpayers under which deductions for losses are allowed when economic performance occurs (economic performance rules), and to methods of accounting that produce consequences economically equivalent to the economic performance rules (such as the special rules for nuclear decommissioning expenses contained in sec. 468A). Congress determined, however, that in order to acknowledge the effect of the time value of money, which was not reflected in the prior-law treatment of loss reserves, it was appropriate to adopt a method of discounting for such reserves.

Explanation of Provision

In general

The Act amends the relevant provisions of subchapter L to provide for the discounting of the deduction for loss reserves to take account partially of the time value of money. Thus, the Act limits the deduction for unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported and resisted claims, and unpaid loss adjustment expenses) to the amount of discounted unpaid losses (new sec. 846 of the Code). Any net decrease in loss reserves results in income inclusion, as under prior law, but the amount to be included is computed on a discounted basis.

This modified treatment of loss reserve deductions is applicable both to loss reserves of property and casualty companies, and to loss reserves of life insurance companies that are not required to be discounted under life insurance reserve rules. In the case of any reserves (including reserves of property and casualty companies) which life insurance company provisions require to be discounted, the applicable life insurance reserve discounting rules apply in lieu of the new discounting rules adopted by the Act.

Special treatment under the Act is provided with respect to (1) certain types of accident and health insurance, including disability insurance, and (2) title insurance.

Scope of discounting

Under the Act, the deduction for losses incurred is computed in the following manner. The amount of losses paid during the taxable year is calculated, and is increased by salvage and reinsurance recoverable (attributable to paid losses) outstanding at the end of the preceding taxable year and is decreased by salvage and reinsurance recoverable (attributable to paid losses) outstanding at the end of the current taxable year. The amount of paid losses is increased by the amount of discounted unpaid losses (as defined in new sec. 846) outstanding at the end of the taxable year and is decreased by the amount of discounted unpaid losses outstanding at the end of the preceding taxable year.

Unpaid losses generally mean the amount of unpaid losses reflected on the annual statement approved by the NAIC that the taxpayer is required to file with insurance regulatory authorities of a State. For purposes of calculating unpaid losses under the Act, unpaid loss adjustment expenses are treated as unpaid losses and are not included in the amount of expenses unpaid (under sec. 832(b)(6)). Unpaid losses are separately defined under the Act to include any unpaid loss adjustment expenses shown on the annual statement; unpaid loss adjustment expenses are not to be taken into account more than once. Under the Act, the Secretary of the Treasury is directed to provide, in regulations, for the proper treatment of salvage and reinsurance recoverable with respect to unpaid losses.

Lines of business to which discounting rules apply

In general.—The Act requires all property and casualty loss reserves (unpaid losses and unpaid loss adjustment expenses) for each line of business (as shown on the annual statement) to be discounted for tax purposes. The lines of business are categories for the reporting of claims and claim payments, and specifically appear on Schedules O and P of the annual statement for property and casualty companies (technically, the "fire and casualty" annual statement as prescribed by the NAIC).

Short-tail lines.—The lines of business reported on Schedule O of the annual statement relate mostly to "short-tail" coverages, such as auto physical damage, although they also include accident and health coverages some of which involve the payment of claims over extended periods, such as so-called long-term disability coverages. "Short-tail" coverages or lines of business are lines of business in which the period of time between the occurrence of the loss for which coverage is provided and the payment of the claim attributable to that loss is, on average, relatively short.[29]

Two of the Schedule O lines are denominated "reinsurance" and "international," respectively, and include amounts that may optionally be reported in those lines or in other Schedule O and P lines to which the reinsurance or international insurance is directly allocable.

Long-tail lines.—The Schedule P lines typically are longer-tail (primarily liability coverage) lines. A "long-tail" line of business is a line in which the time between the occurrence of a loss and the payment of a claim is fairly long. The longer-tail lines of business are denominated in five annual statement categories: auto liability, other liability, workers' compensation, medical malpractice, and multiple peril (encompassing farm owners' multiple peril, homeowners' multiple peril, commercial multiple peril, ocean marine, aircraft (all perils), and boiler and machinery). Under the Act, the multiple peril lines of business are treated as a single line of business for purposes of applying the discounting provisions. Some lines of business, such as workers' compensation and medical malpractice, have significantly longer tails than the other Schedule P lines, with a large percentage of claims remaining unpaid after 10 years.

Accident and health lines.—In the case of insurers which hold loss reserves for cancellable accident and health coverages and are required by the Act to discount such reserves, the amounts involved typically are reported on Exhibits 9 and 11 of the NAIC annual statement for life and health companies.

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[29] Whether a loss has occurred, and the time between occurrence and payment, depends on whether the insurance contract is written on a "loss incurred" or on a "claims made" basis. If insurance is provided on a "loss incurred" basis, coverage is provided with respect to losses that occur during the period of coverage. Alternatively, if a policy is written on a "claims made" basis, coverage is provided with respect to claims reported during the period of coverage. Typically, the time between occurrence of a loss and payment of a claim is shorter if policies are written on a claims made basis.

Because of the presence of potentially longer-tail claims in the accident and health lines as well as in the reinsurance and international lines, the Act provides for special treatment with respect to these types of business, as described more fully below.

Discounting Methodology

In general.—To implement the discounting of loss reserves, the Act provides that the deduction for unpaid losses is limited to the annual increase in discounted unpaid losses. The amount of the discounted unpaid losses as of the end of any taxable year attributable to any accident year is the present value of the losses (as of the close of the taxable year) determined by using (1) the gross amount to be subjected to discounting (i.e., the undiscounted loss reserves), (2) the pattern of payment of claims, including the duration in years over which the claims will be paid, and (3) the rate of interest to be assumed in calculating the discounted reserve.

This discounting methodology is applied by line of business and by accident year, as reported on the annual statement filed for the year. Under the Act, the term accident year means the year in which the incident occurs that gives rise to the related unpaid loss. For this purpose, in the case of a claims made policy, the accident year will generally be the year in which the claim is made.

Limit on discounted losses.—The amounts to which the discounting rules are applied under the Act are the undiscounted loss reserves (as reported on the annual statement for the accident year with respect to the line of business to which the discounting applies). The relevant annual statement is the statement filed by the taxpayer for the fiscal year ending with or within the taxable year of the taxpayer.

In some cases (such as workers' compensation) for certain companies, the reserves shown on the annual statement are already discounted and identified as such. Congress intended that, in the case of a loss reserve that is discounted for purposes of annual statement reporting, the loss reserve for annual statement reporting is grossed up and an undiscounted loss reserve is calculated. This grossing up of discounted loss reserves to undiscounted loss reserves for Federal income tax purposes is available only if the discounting for annual statement reporting is identified as such, and the discounting factors that were used are explained on the annual statement. It is not necessary that the disclosure of discounting be required on the annual statement, as long as the taxpayer actually discloses the fact that unpaid loss reserves are discounted and the basis for such discounting with its annual statement. This undiscounted loss reserve amount is used as the amount of unpaid losses from which the loss reserve discounting for tax purposes is computed.

However, Congress was concerned about the potential for abuse when a property and casualty insurance company computes undiscounted unpaid losses by grossing up any annual statement discounted losses. A company could overstate the undiscounted losses (by overstating the amount by which its unpaid losses are discounted). In such a case, the company could effectively negate the application of the discounting requirements.

One way of dealing with this potential problem would be to require that the discounting rules applicable for income tax purposes be applied to the loss reserves reported on the annual statement, whether or not discounted. Congress believed, however, that such an approach would be inequitable because it would understate some companies' deduction compared to other companies that did not discount for financial reporting purposes. Rather than impose this type of detriment on companies that discount on their annual statements, and thereby possibly interfere with the regulatory authority of the States, the Act imposes a limitation on the ability of a property and casualty insurance company to overstate its discounting factors for annual statement reporting by providing that in no event can the amount of discounted loss reserves for Federal income tax purposes exceed the aggregate amount of unpaid losses (and loss adjustment expenses) with respect to any line of business for an accident year as reported on the annual statement. Further, the amount and rate of the discount, for annual statement purposes, for any line of business, must be ascertainable on the basis of information filed on or with the annual statement. It is anticipated that the Secretary of the Treasury will issue regulations that will prevent taxpayers from manipulating taxable income by adopting inconsistent disclosure practices on annual statements for different years.

Discount factors

In general.—Under the Act, the tax reserve discount factors, computed using the assumptions described below (i.e., the interest rate and the loss payment pattern, including the maximum duration of payments), are to be separately developed for and applied to the unpaid loss attributable to each accident year for each line of business. Recognizing that the computations of the discount factors themselves involve a degree of complexity, it is anticipated that the Secretary will annually publish discount factors which taxpayers may use in determining the discounted amounts of their loss reserves.

Once a series of discount factors is applied to an accident year for a line of business, it continues to be used without change as that accident year "ages" (i.e., as the claims for that year are paid out). In effect, each line of business and accident year is vintaged under the discounting provision, and subsequent redeterminations of the interest rate or payment pattern for that vintage based on actual experience of a particular company or the industry are generally neither required nor permitted.

Interest rate.—The interest rate used for purposes of applying the discounting methodology to a line of business is equal to 100 percent of the average of the applicable Federal mid-term rates (as defined in sec. 1274(d) converted to a rate based on annual compounding) effective as of the beginning of each of the calendar months in the base period. The base period means the most recent 60 calendar months ending before the beginning of the calendar year for which the determination is made. However, no calendar month before August 1986 is included in the base period. For accident years of a company beginning before or in 1987, the rate to be applied is 100 percent of the average of the applicable Federal mid-term rates effective as of the beginning of the 5 last calendar months of 1986.

For example, the rate to be used in computing the discount factors for 1995 is the average of the annual Federal mid-term rates in effect at the beginning of each of the 60 calendar months during 1990-1994. On the other hand, the rate to be used in computing discount factors for 1989 is the average of such applicable rates for the 29-month period ending before January 1, 1989.

Once an interest rate assumption is established with respect to unpaid losses attributable to an accident year, the rate is not subsequently adjusted to reflect changes in the average Federal mid-term rate in later periods. Thus, the interest rate attributable to an accident year is vintaged with respect to that year.

Loss payment pattern.—The Act requires the Secretary of the Treasury to determine a loss payment pattern with respect to each line of business reported on Schedules O and P for a determination year. This loss payment pattern will be determined by reference to the historical loss payment pattern applicable to the line of business and applies to accident years ending with (or within) the determination year and each of the four succeeding years.

The determination year means the calendar year 1987 and each 5th calendar year after 1987. Thus, the Secretary is directed to redetermine and publish the loss payment patterns on an industry-wide basis every 5 years. It is anticipated that Treasury regulations will address the issue of proper application of the discounting rules in the case of taxpayers whose taxable year is not the calendar year (for example, where the taxpayer is a member of an affiliated group filing a fiscal year consolidated return).

Determinations of loss payments patterns are to be made (1) by using the aggregate experience reported on the annual statements of insurance companies to which the discounting provisions apply, (2) on the basis of the most recent published aggregate data from the annual statements relating to loss payment patterns available on the first day of the determination year, (3) by assuming that all losses are paid in the middle of the year, and (4) under certain computational assumptions with respect to the period over which the losses are paid.

At present, the aggregate data derived from the annual statements provides information for the accident year plus 2 years with respect to Schedule O lines of business and the accident year plus 9 years with respect to the Schedule P lines of business. Under the Act, the Secretary is directed to make appropriate adjustments with respect to the duration of payment patterns for future accident years if annual statement data is available for longer periods (e.g., because the period for which reporting is required on the annual statement is changed).

At the current time, aggregate loss payment pattern data is annually published by A.M. Best & Co., summarizing industry payout patterns by line of business and accident year as reported on Schedules O and P of the most recently filed annual statements. Congress intended that, as long as the information is published in its present form and is supplied with respect to at least the same number of accident years as is supplied as of May 6, 1986, the Secretary is to use the data available in Best's Aggregates and Averages.

Under this provision, loss payment patterns announced for the period 1987-1991 are to make use of the most recent published aggregate data available on January 1, 1987, which is the data for 1985. The factors announced during 1992-1996 are to use the data available on January 1, 1992, which is expected to be 1990 data.

Computational rules.—The computational assumptions prescribed by the Act provide that the loss payment pattern for any line of business is to be based on losses paid (1) during the accident year and the 3 years following the accident year or (2) in the case of any line of business reported in the schedule or schedules of the annual statement relating to auto liability, other liability, medical malpractice, workers' compensation, and multiple peril lines of business (Schedule P lines), during the accident year and the 10 years following the accident year.

In the case of a line of business for which the accident year plus the 3 years following the accident year is used (generally, Schedule O lines), the Act provides that losses paid after the first year following the accident year are treated as paid equally in the succeeding 2 years. In the case of any other line of business, losses paid after the close of the 10-year period after the accident year are generally treated as paid in such 10th year.

The Act provides a special rule for certain long-tail lines of business. If the special rule applies, (1) the 10-year period following the accident year may be extended (but not by more than 5 years) and (2) the amount of losses that otherwise would have been treated as paid in the 10th year following the accident year are treated as paid in such 10th year and each subsequent year in an amount equal to the lesser of (a) the amount of losses paid in the 9th year following the accident year, or (b) the remaining amount of unpaid losses. If, at the end of 5 years following such 10th year, there is a remaining balance of unpaid losses, such losses are treated as if paid in such 5th year without regard to the rule in the preceding sentence.

The special rule to extend the assumed loss payment period for long-tail lines of business applies if the amount of losses that would be treated as paid (under the general rule) in the 10th year following the accident year exceeds the amount of losses treated as paid in the 9th year following the accident year.

As an example of this special rule for long-tail lines of business, assume the following loss payment pattern:

Year	Loss payment pattern (percent)
Accident Year	25
Accident Year + 1	10
Accident Year + 2	8
Accident Year + 3	8
Accident Year + 4	8

Year	Loss payment pattern (percent)
Accident Year + 5	7
Accident Year + 6	7
Accident Year + 7	5
Accident Year + 8	5
Accident Year + 9	5
Accident Year + 10	12

In this example, the amount of losses paid in the 9th year following the accident year are less than the amount of losses treated as paid in the 10th year following the accident year. Accordingly, the special rule applicable to long-tail lines of business applies. Under this special rule, the amount of losses paid in the 10th and later years after the accident year are treated as equaling the amount of losses paid in the 9th year after the accident year. Therefore, under the special rule, the loss payment period is extended for an additional 2 years, as follows:

Year	Special rule loss payment pattern (percent)
Accident Year	25
Accident Year + 1	10
Accident Year + 2	8
Accident Year + 3	8
Accident Year + 4	8
Accident Year + 5	7
Accident Year + 6	7
Accident Year + 7	5
Accident Year + 8	5
Accident Year + 9	5
Accident Year + 10	5
Accident Year + 11	5
Accident Year + 12	2

Developing payment patterns.—The Act provides that, if the amount of losses treated as paid in the penultimate year of the payment pattern is zero or negative, then the the average of the amounts treated as paid in the 3 penultimate years of the payment pattern is the amount taken into account for purposes of extending the loss payment pattern by up to an additional 5 years. In the event that the average of the 3 years gives rise to a negative number for any line of business, additional preceding years of the payment pattern should be averaged in successively, until the average is a positive number. This rule applies to the extension of all payment patterns, including those where the taxpayer has elected to determine its loss payment patterns on the basis of its own historical experience (see the discussion below).

The following example illustrates a methodology that would be appropriate, under Treasury regulations, for determining a payment pattern for a line of business for any given accident year. In the case of an electing taxpayer, the data used would be the annual statement data for the line of business reported on the taxpayer's annual statements; the taxpayer's most recently filed annual statement would be appropriate. Example 1 illustrates the development of a payment pattern for a Schedule P line, and example 2 illustrates the development of a payment pattern for a Schedule O line of business. Congress did not intend to preclude the Treasury Department from prescribing additional methodologies for computing loss payment patterns, and applying the resulting discount factors to the unpaid losses reported on the taxpayer's annual statement, to the extent necessary to carry out the purposes of the discounting provision.

Example 1: payment pattern for a Schedule P line

The development of reserve discount factors for a Schedule P line of business is illustrated in Table X-1. This example is based on the 1985 consolidated industry totals for automobile liability. The 1985 annual statement is used because it contains the most recent loss development data.

Table X-1.—Reserve Discount Factor Development, Automobile Liability

[Discount rate is 7.20 percent per annum]

Years before current year	Year loss incurred	Loss and loss expense payments to date [1] (thousands)	Total losses and loss expense incurred (thousands)	Cumulative fraction of loss paid [2] (percent)	Fraction of loss paid during year [3] (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor [4] (percent)
AY + 0	1985	$10,734,519	$31,281,287	34.3161	34.3161	65.6839	58.5753	89.1776
AY + 1	1984	18,397,279	28,217,053	65.1992	30.8830	34.8008	30.8172	88.5530
AY + 2	1983	20,047,428	24,986,353	80.2335	15.0344	19.7665	17.4699	88.3812
AY + 3	1982	19,808,529	22,243,403	89.0535	8.8200	10.9465	9.5957	87.6600
AY + 4	1981	18,974,882	20,225,872	93.8149	4.7614	6.1851	5.3568	86.6075
AY + 5	1980	17,105,852	17,717,217	96.5493	2.7344	3.4507	2.9113	84.3689
AY + 6	1979	16,266,022	16,633,374	97.7915	1.2422	2.2085	1.8348	83.0789
AY + 7	1978	14,534,843	14,766,868	98.4287	.6373	1.5713	1.3071	83.1890
AY + 8	1977	12,853,464	13,027,563	98.6636	.2349	1.3364	1.1580	86.6551
AY + 9	1976	11,389,407	11,506,437	98.9829	.3193	1.0171	.9108	89.5529
AY + 10	Pre-1976	91,306,371	91,545,592	NA	.3193	.6978	.6458	92.5519
AY + 11	NA	NA	NA	NA	.3193	.3785	.3617	95.5694
AY + 12	NA	NA	NA	NA	.3193	.0592	.0571	96.5834
AY + 13	NA	NA	NA	NA	.0592		.0000	96.5834

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[1] "Total losses and loss expense incurred" equals "loss and loss expense payments" plus "losses unpaid" plus "loss expense unpaid" as defined in Schedule P.

[2] "Cumulative fraction of loss paid" equals ratio of "loss and loss expense payments" to "total losses and loss expense incurred".

[3] "Fraction of loss paid during year" equals the change in the "cumulative fraction of loss paid" from the previous year for AY+0 through AY+9) (see text for computation after AY+9).

[4] The reserve discount factor is 96.5834 in AY+12 and all subsequent years.

Schedule P of the 1985 annual statement itemizes "loss and loss expense payments" and "total losses and loss expense incurred" for the 10-year period 1976-1985 and the total for all years before 1976 (see Table X-1). The number of years that have passed since the accident year through the current year (1985) is shown in the first column of Table X-1; for example, the year 1976 is referred to as AY+9. From these data, the cumulative fraction of loss and loss expense paid through 1985, for losses incurred in 1976-1985, is computed as the ratio of "loss and loss expense payments" to "total losses and loss expense incurred". For AY+0 through AY+9, the fraction of loss and loss expense paid during each accident year is estimated as the change in the cumulative fraction of loss and loss expense paid from the previous accident year. Since unpaid loss and loss expense at the end of AY+9 (1.0171 percent) exceeds the amount of loss and loss expense payments in AY+9 (0.3193 percent), the special rule for long-tail lines is applicable. Under this rule, unpaid loss and expenses at the end of AY+9 are deemed to be paid at a rate of 0.3193 percent in AY+10 through AY+12, and the balance, 0.0592 percent, is deemed to be paid in AY+13.

The reserve discount factors are equal to the ratio of discounted unpaid losses to undiscounted unpaid losses in each accident year. For purposes of discounting, losses are deemed to be paid in the middle of the year. For example, if the discount rate is 7.20 percent, then the discounted unpaid loss in AY+11 is computed as the present value of losses deemed to be paid in AY+12 and AY+13:

$$0.3617 = \frac{0.3193}{1.0720^{1/2}} + \frac{0.0592}{1.0720^{3/2}}$$

Consequently, as shown in Table X-1, the reserve discount factor for AY+11 is 95.5694 percent,[30] i.e., the ratio of discounted unpaid losses (0.3617 percent) to undiscounted unpaid losses (0.3785 percent) in AY+11. The reserve discount factor for the year that the last claim is deemed to be paid (AY+13), and for all subsequent years, is the reserve discount factor for the preceding year (96.5834 percent in AY+12).

Example 2: payment pattern for a Schedule O line

The development of reserve discount factors for a Schedule O line of business is illustrated in Table X-2. This example is based on the 1985 consolidated industry totals for fire insurance. The 1985 annual statement is used because it contains the most recent loss development data.

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[30] To obtain this degree of accuracy in the reserve discount factor, the percent of losses deemed paid in AY+12 (0.319307) and AY+13 (0.0591628) must be carried out to six significant digits.

Table X-2.—Reserve Discount Factor Development. Fire Insurance

[Discount rate is 7.26 percent per annum]

Years before current year	Year loss incurred	Net losses paid in year (thousands)	Unpaid losses beginning year [2] (thousands)	Fraction unpaid loss in year [3] (percent)	Fraction of total loss paid in year [4] (percent)	Fraction of total loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor [5] (percent)
AY + 0	1985	$1,182,445	$2,142,829	55.1815	55.1815	44.8185	42.1262	93.9928
AY + 1	1984	687,222	944,426	72.7661	32.6127	12.2058	11.3929	93.3400
AY + 2	Pre-1984	196,764	462,600	NA	6.1029	6.1029	5.8944	96.5834
AY + 3		NA	NA	NA	6.1029	0	0	96.5834

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[1] "Net losses paid in year" equals "losses paid during the year less reinsurance received during the year" less "salvage and subrogation received in the currrent year" as defined in Schedule O.

[2] "Unpaid losses, beginning year" equals "net losses paid in year" plus "losses unpaid" as defined in Schedule O.

[3] "Fraction unpaid loss paid in year" equals ratio of "net losses paid in year" to "unpaid losses, beginning year".

[4] "Fraction of total loss paid in year" equals "fraction unpaid loss paid in year" times previous year's "fraction of total loss unpaid, year-end" for AY+0 and AY+1 (see text for computation after AY+1).

[5] The reserve discount factor is 96.5834 in AY+2 and all subsequent years.

Schedule O of the 1985 annual statement itemizes "losses paid" and "losses unpaid" for the 2-year period 1984-1985 and the total for all years before 1984 (see Table X-2).[31] The number of years that have passed since the accident year through the current year (1985) is shown in the first column of Table X-2; for example, the year 1984 is referred to as AY+1. From these data, the fraction of unpaid losses paid in 1985, for losses incurred in 1984 and 1985, is computed as the ratio of "net losses paid in year" to "unpaid losses, beginning year". For AY+0 and AY+1, the fraction of total loss paid in the current year is estimated as the fraction of unpaid losses paid in the current year times the previous year's fraction of total loss unpaid at year-end. The fraction of loss paid during AY+2 and AY+3 is deemed to be one-half of the fraction of total loss unpaid at the end of AY+1 (6.1029 percent equals one-half of 12.2058 percent).

The reserve discount factors are equal to the ratio of discounted unpaid losses to undiscounted unpaid losses in each accident year. For purposes of discounting, losses are deemed to be paid in the middle of the year. For example, if the discount rate is 7.20 percent, then the discounted unpaid loss in AY+1 is computed as the present value of losses deemed to be paid in AY+2 and AY+3:

$$11.3929 = \frac{6.1029}{1.0720^{1/2}} + \frac{6.1029}{1.0720^{3/2}}$$

Consequently, as shown in Table X-2, the reserve discount factor for AY+1 is 93.3400 percent, the ratio of discounted unpaid losses (11.3929 percent) to undiscounted unpaid losses (12.2058 percent) in AY+1. The reserve discount factor for the year that the last claim is deemed to be paid (AY+3), and for all subsequent years, is the reserve discount factor for the preceding year (96.5834 percent in AY+2).

Special rule for international and reinsurance

Under the Act, for loss reserves for the international and reinsurance lines of business that are not specifically allocated to a particular line of business, the discounting provisions are implemented on the basis of composite discount factors derived by combining the payment patterns for all Schedule P lines. Although reinsurance and international lines of business may be reported on Schedule O as short-tail lines of business, Congress was concerned that treating these lines as Schedule O lines for purposes of calculating discounted loss reserve deductions would create a disproportionately favorable effect on unallocated loss reserves for reinsurance and international insurance attributable to long-tail lines of business. If such long-tail lines were accurately reflected, the current loss reserve deduction would be lower than if such reinsurance and international insurance is treated as part of a Schedule O line of business, with assumed loss payments over a much shorter period of time.

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[31] Part 1 of Schedule O contains data on losses; part 2 contains data on loss adjustment expense. In this example, loss adjustment expense is disregarded because the consolidated industry totals for part 2 data are not published. A taxpayer electing its own experience is required to compute reserve discount factors using combined loss and loss expense development data.

The Act authorizes the Secretary to issue regulations requiring a company to follow a loss payment pattern that differs from the normal treatment of reinsurance as a composite of all Schedule P lines of business. Congress anticipated, for example, that in the case of a company substantially all of the reinsurance business of which is the reinsurance of medical malpractice insurance, the Secretary is to require such reinsurer to use a loss payment pattern that is an aggregate of all industry experience with respect to medical malpractice, rather than an aggregate of all industry experience for all Schedule P lines of business.

Generally, international and reinsurance business that is allocated to a particular line of business and taken account of as part of that line of business is discounted in accordance with the rules applicable to that line of business, not the general rules applicable to unallocated international and reinsurance business. Thus, for example, reinsurance of accident and health business that is allocated to that line of business as reported on the annual statement of the taxpayer is subject to the discounting rules applicable to that line of business. The Treasury Department may, by regulation, address the treatment of distortions in the loss payment patterns arising where, for example, reinsurance of "short-tail" business is allocated to that line of business and reinsurance of "long tail" business is unallocated, or vice versa.

Special rules for accident and health insurance coverage

Under the Act, the active life reserves held for life insurance and noncancellable accident and health benefits (to the extent subject to the life insurance company reserve rules (sec. 807(d)) are not subject to discounting under the new discounted unpaid loss provisions (sec. 846). Rather, in the case of a property and casualty insurance company subject to the life insurance reserve rules with respect to a particular line of business, the amount of discounted unpaid losses for that line of business is the amount required under the life insurance reserve rules.

Life insurance companies may not deduct loss adjustment expenses that do not meet the all-events test applicable under sec. 461 of the Code. Thus, it is not intended that noncancellable accident and health insurance business currently subject to life insurance reserve rules (sec. 807(d)) be subject to discounting under the property and casualty discounting methodology. Similarly, life insurance companies are not intended to be permitted to deduct loss adjustment expenses by virtue of the application of the property and casualty discounting methodology with respect to cancellable accident and health insurance business, if any, of such companies.

Under the Act, in the case of unpaid losses relating to disability insurance (other than credit disability insurance), the general rules prescribed for the treatment of noncancellable accident and health insurance contracts under the life insurance company reserve provisions (sec. 807(d)) are to apply, adjusted in the following manner: (1) the taxpayer may use its own experience relating to mortality and morbidity, (2) the prevailing State assumed interest rate to be used is the rate in effect for the year in which the loss occurred rather than the year in which the contract was issued, and (3) the rule limiting the amount of discounted losses to no more than the aggregate amount of unpaid losses as reflected on the annual statement applies. Similar treatment applies to noncancellable accident and health insurance provided by a life or by a property and casualty insurance company.

In the case of life insurance companies and property and casualty companies with respect to the types of accident and health insurance coverage (other than disability insurance) that are not currently subject to the life insurance company reserve requirements (such as cancellable accident and health coverage), such coverage is subject to the discounting provisions for property and casualty companies. It is assumed, for purposes of applying such provisions, that unpaid losses at the end of an accident year are paid in the middle of the year following the accident year. The type of insurance to which this rule applies is primarily medical reimbursement coverage.

Further, one type of accident and health insurance (credit disability) is more in the nature of a property and casualty type of line of business and, under the Act, is treated as a Schedule O line of business. While Congress did not consider it appropriate to treat credit disability in the same manner as life insurance, it concluded that treatment in the same manner as medical reimbursement would not reflect the typical loss payment pattern of such disability coverage. Therefore, credit disability is discounted over the same period as Schedule O lines of business.

Election by company to use its own experience

Under the Act, a taxpayer may elect to apply the general loss discounting rules by reference to the taxpayer's own historical loss payment pattern as of the end of a taxable year (the determination year). The taxpayer, if the election is made, is to use the taxpayer's most recent experience as reported on its annual statement. For each of the 5 years in the determination period, the taxpayer's most recent experience is to be used. Once a determination has been made by a taxpayer with respect to an accident year and line of business, the taxpayer may not redetermine its loss payment pattern to adjust for more recent information. This treatment is consistent with the general vintaging approach used for determining loss payment patterns on the aggregate experience for the industry.

The election by a taxpayer to use its own experience, once made, applies to all accident years and all lines of business of the taxpayer (except international and reinsurance lines, for which no election is permitted), and may not be revoked without the consent of the Secretary. The election may be made with respect to any determination year and applies for that determination year and the 4 succeeding calendar years. As under the general rules, the determination year is calendar year 1987 and each 5th succeeding calendar year after 1987.

Congress intends that the Secretary will permit companies to derive their loss payment patterns based on the information reported on the annual statement. To determine the assumed loss payment pattern for each "vintage" (i.e., accident year for a line of business), the following method may be used. The amount of losses deemed to be paid for the vintage in the current taxable year with respect to any vintage is the total paid losses for the vintage for the taxable year, divided by the total of paid and unpaid losses for the vintage in that taxable year, minus the same calculation for the subsequent vintage done for the taxable year.

For example, assume that a company's annual statement for 1985 shows that, for a line of business with an accident year of 1980 with total incurred losses of $100, $65 dollars are paid losses and $35 are unpaid losses. With respect to accident year 1981, for total incurred losses of $180, $60 dollars have been paid and $120 are unpaid losses. To determine the loss payment pattern for that line of business for the accident year plus 5 (i.e., 1980 is the accident year and 1985 is the accident year plus 5), the percentage of losses deemed paid in the accident year plus 5 (65 divided by 100 or 65 percent) is reduced by the percentage of losses deemed paid in the accident year plus 4 (60 divided by 180 or 33⅓ percent). Therefore, the percentage of incurred losses deemed paid in the accident year plus 5 is 65 percent minus 33⅓ percent or 31⅔ percent.

Under the Act, Treasury regulations may provide that an election under this provision does not apply to a line of business in which the taxpayer does not have sufficient historical experience. Generally, it is intended that the election be available only for those lines of business for which the taxpayer's own historical experience is statistically significant. Thus, if the taxpayer's business in any line of business does not represent a meaningful portion of the total industry-wide business in that line of business, then it is intended that the election not apply with respect to that line of business. Generally, the Treasury Department is directed to develop regulations to carry out this intent. Such regulations might, for example, determine that a meaningful portion would be a portion representing business in at least the 10th percentile of industry-wide reserves for a line of business for the determination year with respect to which the election is made. For example, no election would be permitted for any line of business where 90 percent of taxpayers that have reserves in that line of business, have reserves that are bigger than those of the taxpayer for the line of business for the determination year.

Title insurance reserves

In the case of title insurers, the Act provides that the amount of the taxpayer's unearned premium reserve determined under prior law is subject to discounting at the rate generally applicable to property and casualty insurers unpaid loss reserves (sec. 832(b)(8) of the Code).[32] The amount of the unearned premium reserve subject to discounting is the amount shown on the yearly statement filed for State insurance regulatory purposes for the fiscal year ending with or within the taxable year. The loss payment pattern to be applied for purposes of discounting these reserve amounts is the period and pattern over which such reserves for that year are to be included in income in accordance with applicable State law. The rate and amount of inclusion in income for statutory accounting purposes is considered to determine the timing of and amount of releases from such reserve which are included in income for income tax purposes. The applicable interest rate is the rate applicable, for the year the premiums are received, under the loss reserve discounting rules applicable to property and casualty insurance companies.

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[32] No inference is intended with respect to the applicability of Rev. Ruls. 83-174 and 84-107, above.

Title insurance case reserves (i.e., known claims reserves) are subject to discounting under the provisions generally applicable to property and casualty insurance loss reserves.

A fresh start for discounting title insurance reserves is provided, calculated in a manner similar to the fresh start for other property and casualty company loss reserves (see the discussion below).

This treatment is provided for title insurance reserves because of the deferral and the consequent failure to acknowledge the time value of money which resulted under prior law with respect to title insurance unearned premium reserves.

Effective Dates

Under the Act, the provisions relating to the treatment of unpaid loss reserve deductions for property and casualty companies apply to taxable years beginning after December 31, 1986.

Under the Act, a transitional rule is provided with respect to the unpaid losses on outstanding business before the effective date of the provision. Under this transitional rule, for purposes of calculating a company's change in unpaid losses with respect to outstanding business, the unpaid losses at the end of the last taxable year beginning before January 1, 1987, and the unpaid losses as of the beginning of the first taxable year beginning after December 31, 1986, are determined as if the discounting provisions had applied to the unpaid losses (and unpaid expenses) in the last taxable year beginning before January 1, 1987. In addition, the interest rate and loss payment pattern assumptions with respect to such outstanding business is to be computed by using the rate and loss payment pattern applicable to accident years ending in 1987.

Further, the Act provides a fresh start with respect to undiscounted loss reserves applicable to the last taxable year beginning before January 1, 1987. Under this fresh start rule, the difference between the amount of undiscounted unpaid loss reserves and unpaid expenses (the recomputed reserves) at the end of the last taxable year beginning before January 1, 1987, and the amount of the discounted balances determined under the transitional rule, are not taken into account for purposes of determining the taxable income of an insurance company after the effective date.[33] The fresh-start rule also applies to differences in reserves attributable to the change in the period for determining loss of companies whose taxable year is not the calendar year.

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[33] In the case of an insurance company that first becomes fully taxable (i.e., not exempt under sec. 501(c)(15) and not electing under sec. 831(b) to be taxed only on investment income) in a later taxable year, e.g., 1995, the fresh start adjustment should be made with respect to the company's undiscounted loss reserves at the close of the year immediately preceding such year. A technical correction may be needed so that the statute reflects this intent.

Such fresh start adjustment is to be taken into account in full in the first taxable year to which the discounting provisions apply (i.e., the first taxable year beginning after December 31, 1986), for purposes of calculating any adjustment to earnings and profits. Reserve strengthening in taxable years beginning after December 31, 1985, is not treated as a reserve amount for purposes of determining the amount of the fresh start. Instead, such reserve strengthening additions to unpaid loss reserves in taxable years beginning in 1986 are treated as changes to reserves in taxable years beginning in 1987, and are subject to discounting. This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision. The deduction for reserve strengthening is not to be taken into account twice.

Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. Reserve strengthening does not include amounts reported to the insurance company from mandatory state or Federal assigned risk pools, if the amount of the loss reported is not discretionary with the insurance company.

4. Protection against loss account for mutual companies (sec. 1024 of the Act and former sec. 824 of the Code)[34]

Prior Law

Under prior law, mutual property and casualty insurance companies were permitted a deduction for contributions (which are bookkeeping entries) to a protection against loss ("PAL") account (sec. 824). The amount of the deduction was equal to the sum of 1 percent of the underwriting losses for the year plus 25 percent of statutory underwriting income, plus certain windstorm and other losses. In general, contributions to the PAL account were taken into income after a 5-year period. The PAL account thus effected a 5-year deferral of a portion of mutual company underwriting income.

Reasons for Change

The intent of Congress in enacting the PAL provision had been to provide mutual companies with a source of capital to enable them to compete with stock companies, in the event of a catastrophic loss. While stock companies could enter capital markets and issue new stock to raise money in the event of a catastrophic loss, a mutual company, because it does not issue stock, could not do so. The 5-year partial income deferral provided a source of capital not available to stock companies.

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[34] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1024; H.Rep. 99-426, pp. 676-677; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1023; S.Rep. 99-313, pp. 510-511; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 369-370 (Conference Report).

In adopting the provisions of the Act, however, Congress expressed the belief that the deduction for contributions to the PAL account was not serving its intended purpose and therefore should be repealed. The PAL rules did not require that any funded account actually be maintained to protect against losses; rather, the only protection was afforded in the form of tax savings. The utility of the PAL was greatest where least needed, in the case of mutual companies with current taxable income that could benefit from deferral. Further, the comparison to the ability of stock companies with catastrophic losses to raise funds in capital markets may not have been entirely appropriate, because any company may not readily be able to raise funds when its financial prospects are dimmed by serious losses.

Explanation of Provision

Code section 824, allowing a deduction for contributions to a PAL account, is repealed. Amounts credited to PAL accounts in taxable years beginning before December 31, 1986, are included in income in accordance with prior law (as if sec. 824 remained in effect).

Effective Date

The repeal of the deduction for contributions to a PAL account is effective for taxable years beginning after December 31, 1986.

5. Special exemptions, rates, and deductions of small mutual companies; combination of Parts II and III of subchapter L (sec. 1024 of the Act and secs. 501, 821, 823 and 831 of the Code)[35]

Prior Law

Under prior law, mutual property and casualty companies were classified into three categories depending upon the amounts of the company's gross receipts. Mutual companies with certain gross receipts not in excess of $150,000 were exempt from tax (sec. 501(c)(15)). Companies whose gross receipts exceeded $150,000 but did not exceed $500,000 were "small mutuals" and generally were taxed solely on investment income. This provision did not apply to any mutual company that had a balance in its PAL account, or that, pursuant to a special election, chose to be taxed on both its underwriting and investment income. Additionally, small mutuals which were subject to tax because their gross receipts exceed $150,000 could claim the benefit of a special rule which phased in the regular tax on investment income as gross receipts increased from $150,000 to $250,000. Companies whose gross receipts exceeded $500,000 were ordinary mutuals taxed on both investment and underwriting income. Mutual reciprocal underwriters or interinsurers were generally taxed as mutual insurance companies, subject to special rules (sec. 826).

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[35] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1025; H.Rep. 99-426, pp. 677-678; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1024; S.Rep. 99-313, pp. 511-512; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 369-370 (Conference Report).

Like stock companies, ordinary mutuals generally were subject to the regular corporate income tax rates. Mutuals whose taxable income did not exceed $12,000 paid tax at a lower rate. No tax was imposed on the first $6,000 of taxable income, and a tax of 30 percent was imposed on the next $6,000 of taxable income. For small mutual companies that were taxable on investment income, no tax was imposed on the first $3,000 of taxable investment income, and a tax of 30 percent was imposed on taxable investment income between $3,000 and $6,000.

Mutual companies that received a gross amount from premiums and certain investment income of less than $1,100,000 were allowed a special deduction against their underwriting income (if it was subject to tax). The maximum amount of the deduction was $6,000, and the deduction was phased out as the gross amount increased from $500,000 to $1,100,000.

Reasons for Change

Congress determined that the prior-law rules applicable to small and certain ordinary mutual companies were inordinately complex and should be simplified. Congress concluded that one provision should afford benefits comparable to prior law to small mutual companies. Further, Congress concluded that it was appropriate to eliminate the distinction between small mutual companies and other small companies, and extended the benefit of the small company provision to all eligible small companies, whether stock or mutual.

Explanation of Provision

The Act provides that mutual and stock property and casualty companies are eligible for exemption from tax if their net written premiums or direct written premiums (whichever is greater) do not exceed $350,000. This provision changes the nature of the ceiling amount for tax exemption from certain gross receipts to direct or net written premiums, and increases the ceiling amount from $150,000 to $350,000.

In addition, the Act repeals the special rates, deductions and exemptions for small mutual companies and substitutes a single provision (sec. 831(b) of the Code). The new provision allows mutual and stock companies with net written premiums or direct written premiums (whichever is greater) in excess of $350,000 but less than $1,200,000 to elect to be taxed only on taxable investment income. To determine the amount of direct or net written premiums of a member of a controlled group of corporations, the direct or net written premiums of all members of the controlled group are aggregated. In determining whether a taxpayer is a member of a controlled group of corporations for purposes of eligibility for the provision, a 50 percent ownership test applies.

Parts II and III of subchapter L of the Code are consolidated into Part II, under the Act. Part II of subchapter L relates generally to taxation of property and casualty insurance companies.

Effective Date

The provisions are effective for taxable years beginning after December 31, 1986.

6. Study of treatment of property and casualty insurance companies (sec. 1025 of the Act)[36]

Prior Law

Under prior and present law, property and casualty insurance companies are generally permitted to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. Stock companies could not, however, fully deduct dividends paid to shareholders. Policyholder dividends and shareholder dividends are treated differently for tax purposes at the distributee level as well as at the company level. Policyholder dividends are generally considered price rebates and are not taxable distributions (unless the insurance premiums were deducted by the policyholder). Dividends paid to shareholders in their capacity as shareholders, on the other hand, constitute ordinary income to the recipient shareholders to the extent of the distributing corporation's earnings and profits. Unlike mutual property and casualty companies, however, mutual life insurance companies reduce the amount of deductible policyholder dividends by an amount intended to reflect the portion of the distribution allocable to the companies' earnings on equity (as distinguished from the proportion which is a policyholder rebate).

Reasons for Change

Congress recognized that there may be inequity arising from the difference in tax treatment of dividend distributions of stock property and casualty companies, and policyholder dividends of mutual companies. It may be appropriate, as in the case of life insurance companies, to treat a portion of mutual property and casualty company policyholder dividends as a distribution of earnings on equity of the company; however, the rule applying this concept in the life insurance area is enormously complex and controversial in application. Therefore, before applying the concept (or another approach, if preferable) to property and casualty insurers, Congress believed it would be preferable to review the results and recommendations of a study to be conducted by the Treasury Department.

Congress also concluded that it is important to monitor the new property and casualty insurance provisions to see that their purpose to measure more accurately the income of property and casualty insurers is being carried out. Similarly, Congress concluded that it is important to monitor the application of the corporate minimum tax (whose purpose is to ensure that all taxpayers pay a minimum amount of tax on their income) to property and casualty insurers.

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[36] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 1026 and 1027; H.Rep. 99-426, pp. 678-680; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 368-369 (Conference Report).

Explanation of Provision

The Act requires the Treasury Department to conduct a study of property and casualty company taxation issues covering several areas. One issue is the tax treatment of policyholder dividends by mutual property and casualty insurance companies, including corporate minimum tax issues and regular tax issues relating to the tax treatment of policyholder dividends of mutual property and casualty insurance companies. In addition, the study is to cover the operation and effectiveness of the provisions in the Act relating to the regular and minimum tax of property and casualty insurance companies, and is to examine whether the revenue targets projected for the provisions are met. The Treasury Department has the authority under the Act to require the furnishing of information necessary to conduct the study. The results of the study, together with recommendations, are to be submitted to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate and the Joint Committee on Taxation no later than January 1, 1989, so that Congress may take such further action as is appropriate.

7. Physicians' and surgeons' mutual protection associations (sec. 1031 of the Act)[37]

Prior Law

In general, under prior and present law, the gross income of a mutual insurance company (other than a life insurance company) includes gross premiums and other consideration, gross investment income, and gain from the sale or other disposition of property. Prior and present law provide a special deduction for dividends and similar distributions paid to policyholders in their capacity as such.

In the case of corporations, gross income does not include any contribution to capital (sec. 118). However, under prior and present law, the provisions covering the taxation of nonlife mutual insurance companies have no specific provisions regarding paid-in capital or the distribution of such capital.

Premiums for liability insurance in carrying on any trade or business generally are deductible in the year they are paid or incurred if they represent ordinary and necessary business expenses and were not capital expenditures. For example, annual premiums paid by a physician for medical malpractice insurance generally are deductible. No deduction is allowed as an expense paid or incurred during the taxable year for a contribution to capital.

Reasons for Change

Congress determined that it is appropriate to provide for the tax treatment of organizations operating before 1984 as pooled malpractice insurance associations.

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[37] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S7956-7958 (June 19, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 371-372 (Conference Report).

Explanation of Provision

Contributions to a pooled malpractice insurance association are currently deductible to the extent they do not exceed the cost of a commercial insurance premium for annual coverage and are included in the association's income. Refunds of such contributions are deductible to the fund only to the extent included in the income of the recipient. The provision applies to associations operating under State law prior to January 1, 1984.

Effective Date

The provision is effective for contributions and refunds after the date of enactment (October 22, 1986).

Revenue Effect of Part C (Property and Casualty Insurance Company Taxation)

The provisions of Part C are estimated to increase fiscal year budget receipts by $871 million in 1987, $1,454 million in 1988, $1,636 million in 1989, $1,745 million in 1990, and $1,842 million in 1991.

TITLE XI—PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

A. Limitations on Treatment of Tax-Favored Savings

1. Individual retirement arrangements (IRAs) (secs. 1201-1203 of the Act and secs. 219 and 408 of the Code)[1]

Prior Law

IRA deduction limit

Under prior law (sec. 219), an individual who had not attained age 70½ generally was entitled to deduct from gross income (within limits) the amount contributed to an individual retirement arrangement (an IRA). The limit on the deduction for a taxable year generally was the lesser of $2,000 or 100 percent of compensation (earned income, in the case of income from self-employment).

Prior to the Economic Recovery Tax Act of 1981 (ERTA), deductible IRA contributions were not permitted for any taxable year if an individual, for any part of the taxable year, was an active participant in a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)), a tax-sheltered annuity program (sec. 403(b)), a qualified annuity plan (sec. 403(a)), or a governmental plan (whether or not tax qualified). Nondeductible IRA contributions were not permitted.

ERTA provided that deductible IRA contributions (within limits) could be made by all individuals, without regard to whether an individual was covered under an employer's retirement plan.

Spousal IRA deduction

Under a spousal IRA, an individual was allowed an additional deduction for contributions to an IRA for the benefit of the individual's spouse if (1) the spouse had no compensation for the year; (2) the spouse had not attained age 70½; and (3) the couple filed a joint income tax return for the year. If deductible contributions were made (1) to an individual's IRA and (2) to an IRA for the noncompensated spouse of the individual (a spousal IRA), then the annual deduction limit on the couple's joint return was increased to the lesser of $2,250 or 100 percent of compensation includible in gross income. The annual contribution could be divided as the spouses chose, so long as the contribution for neither spouse exceeded $2,000. If a spouse had a small amount of compensation, including amounts less than $250, the spousal IRA deduction was not available under prior law.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1101; H.Rep. 99-426, pp. 682-85; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1201-1204; S.Rep. 99-313, pp. 541-547; Senate floor amendment, 132 Cong. Rec. S7931-7932 (June 19, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 373-380 (Conference Report).

Qualified voluntary employee contributions

Prior law allowed an employee who was a participant in a qualified plan, tax-sheltered annuity program, or government plan a deduction for qualified voluntary employee contributions made by or on behalf of the employee to the plan. The deduction allowed for contributions to an IRA was reduced by the amount of deductible voluntary employee contributions to a plan. Thus, the deduction allowed for the total of (1) an employee's contributions to an IRA and (2) the employee's qualified voluntary employee contributions to a plan (or plans) for a year, generally was limited to the lesser of $2,000 or 100 percent of compensation for the year.

Acquisition of gold and silver coins

Prior and present law provides that the acquisition by an IRA of any collectible is treated as a distribution from the IRA equal to the cost of the collectible and is includible in the IRA owner's income for the year in which the cost is deemed distributed. Under prior law, a collectible included any coin, including a coin issued by the United States.

Reasons for Change

The individual retirement savings provisions of the Code were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA) to provide a tax-favored retirement savings arrangement to individuals who were not covered under a qualified plan, a tax-sheltered annuity program, or a governmental plan maintained by their employer. At that time, individuals who were active participants in employer plans were not permitted to make deductible IRA contributions.

In the Economic Recovery Tax Act of 1981 (ERTA), Congress eliminated the active participant restriction and extended IRA availability to all taxpayers. At that time, the Congress articulated a concern about the level of savings generally and expressed a desire to provide a discretionary retirement savings arrangement that was uniformly available.

Congress determined that, since 1981, the expanded availability of IRAs had no discernible impact on the level of aggregate personal savings. In addition, many employers had adopted qualified cash or deferred arrangements, which permit employees to make discretionary contributions that are provided with tax-favored treatment essentially equivalent to that accorded to deductible IRA contributions. The limits on elective deferral under cash or deferred arrangements are substantially higher (even after the reductions included in the Act) than the limits on IRA contributions, but are subject to nondiscrimination rules designed to promote participation by lower-paid employees. In addition, many employees of tax-exempt organizations are permitted to make significant elective deferrals under tax-sheltered annuity programs. Congress believed that the wide availability of the option to make elective deferrals under cash or deferred arrangements and tax-sheltered annuities reduced the prior concern that individuals in employer-maintained plans should be able to save additional amounts for retirement on a discretionary basis.

Further, Congress determined that data had consistently shown that IRA utilization was quite low among lower-income taxpayers who could be the least likely to accumulate significant retirement savings in the absence of a specific tax provision. For example, for the 1984 tax year, only 7.8 percent of returns with adjusted gross income (AGI) under $30,000 (who represent 76 percent of all taxpayers) made IRA contributions, whereas 59 percent of returns with AGI of $50,000 or more made IRA contributions. It was clear to Congress, therefore, that utilization of the IRA deduction increased substantially as income increases.

Congress believed that those taxpayers for whom IRA utilization was the largest (i.e., higher-income taxpayers) would generally have saved without regard to the tax incentives. Congress further believed that the substantially lower tax rates provided by the Act, which themselves stimulate additional work effort and saving, eliminate the need for IRA deductions for higher-income taxpayers who participate in other tax-favored retirement plans. Thus, with respect to higher-income taxpayers, Congress found it appropriate to reinstate generally the rules prior to ERTA, which limit IRA deductions to those taxpayers who are not covered by an employer-provided pension plan.

However, Congress also wished to provide a tax incentive for discretionary retirement savings for all taxpayers. Therefore, the Act permits all individuals, including higher-income taxpayers who are covered by an employer's retirement plan, to make nondeductible contributions to an IRA with a continued deferral of tax on the earnings on these nondeductible contributions.

In addition, Congress recognized that the current spousal IRA deduction limit creates anomalous results in the case of a spouse whose compensation is less than $250 a year. The Act eliminates this anomaly for purposes of determining eligibility to make deductible or nondeductible spousal IRA contributions.

Explanation of Provisions

IRA deduction not available to active participants

In general

The Act generally retains the prior-law IRA provisions for taxpayers who are not active participants in an employer-maintained retirement plan and for taxpayers with adjusted gross income (AGI) below certain levels, and reduces the IRA deduction for active participants with AGI above those levels.

Under the Act, a taxpayer is permitted to make deductible IRA contributions up to the lesser of $2,000 or 100 percent of compensation (earned income, in the case of a self-employed individual) if:

(1) in the case of a taxpayer who is not married, the taxpayer either (a) has AGI that does not exceed the applicable dollar amount or (b) is not an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year;

(2) in the case of married taxpayers filing a joint return, either (a) the couple has AGI that does not exceed the applicable dollar amount or (b) neither spouse is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year; or

(3) in the case of a married taxpayer filing separately, the taxpayer either (a) has AGI that does not exceed the applicable dollar amount, or (b) neither spouse is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year.

The applicable dollar amount is (1) $25,000, in the case of an unmarried individual, (2) $40,000, in the case of a married couple filing a joint return, and (3) $0, in the case of a married taxpayer filing separately. The otherwise applicable IRA dollar limit (i.e., $2,000) is reduced by an amount that bears the same ratio to such dollar limit as the taxpayer's AGI in excess of the applicable dollar amount (or, in the case of a married couple filing a joint return, the couple's AGI in excess of the applicable dollar amount) bears to $10,000. Thus, under the Act, in the case of an active participant, the IRA deduction limit is $0 for (1) unmarried individuals who have AGI equal to or greater than $35,000, (2) married couples filing a joint return who have AGI equal to or greater than $50,000, and (3) married taxpayers who have AGI equal to or greater than $10,000.

For purposes of determining whether an IRA contribution is deductible for a taxable year, a taxpayer is not considered married for a year if the taxpayer and the taxpayer's spouse (1) did not live together at any time during the taxable year, and (2) did not file a joint return for the taxable year.[2]

Under the Act, the spousal IRA dollar limit is also proportionately reduced for AGI above the applicable dollar amount. Thus, the spousal IRA dollar limit (i.e., $2,250) is reduced by an amount that bears the same ratio to $2,250 as the excess of AGI over the applicable dollar amount bears to $10,000.

The dollar limit is rounded to the next highest $10 in the case of a limit that is not a multiple of $10. In addition, the Act provides a $200 floor on the IRA dollar limit for individuals whose AGI is not above the phaseout range. For example, an individual with AGI of $34,500 has an IRA dollar limit of $200 even though the phaseout would otherwise provide an IRA dollar limit of $100.

Under the Act, the 100 percent of compensation limit on IRA deductions is applied after the phaseout. For example, assume a married couple filing jointly has total AGI of $45,000, with one spouse having AGI of $44,000 and the other spouse having AGI of $1,000. One spouse is an active participant in an employer-maintained retirement plan. Under the phaseout, the $2,000 dollar limit for each spouse is reduced to $1,000. Because each spouse has AGI of at least $1,000, each spouse may make a $1,000 deductible contribution to an IRA. On the other hand, if one spouse had AGI of $44,500 and the other spouse had AGI of $500, then the spouse with

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[2] A technical correction may be needed so that the statute reflects this intent.

AGI of $44,500 could make a deductible contribution of $1,000, and the other spouse could make a deductible contribution of only $500.

AGI, for purposes of determining the IRA dollar limit, is calculated without regard to any deductible IRA contributions made for the taxable year and without regard to the exclusion provided for certain foreign earned income (sec. 911), but with regard to any taxable social security benefits (sec. 86) and with regard to any passive loss limitations (new sec. 469). In other words, AGI is calculated in the following order: (1) for purposes of the limitations on passive loss deductions, (2) for purposes of the amount of social security benefits that are taxable, and (3) for purposes of the IRA deduction limit.

Active participant

Under the Act, an individual is an active participant in an employer-maintained retirement plan with respect to the individual's taxable year if the individual is an active participant for any part of the plan year ending with or within the individual's taxable year. For purposes of this rule, an employer-maintained retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan; (2) a qualified annuity plan (sec. 403(a)); (3) a simplified employee pension (sec. 408(k)); (4) a plan established for its employees by the United States, by a State or political subdivision, or by any agency or instrumentality of the United States or a State or political subdivision (other than an unfunded deferred compensation plan of a State or local government (sec. 457)); (5) a plan described in section 501(c)(18); or (6) a tax-sheltered annuity (sec. 403(b)).

With certain modifications, the Act generally follows the pre-ERTA rule for determining whether an individual is an active participant in an employer-maintained retirement plan.[3]

The determination of active participant status is dependent upon the type of plan in which the individual participates or is eligible to participate. In the case of a defined benefit pension plan, an individual is treated as an active participant if the individual is not excluded under the eligibility requirements under the plan for any part of the plan year ending with or within the individual's taxable year. Further, an individual is considered an active participant in a defined benefit plan if the individual is eligible to participate in the plan, even if the individual elects not to participate. Thus, for example, if an individual satisfies the conditions for eligibility under a defined benefit pension plan, but is required to make an employee contribution to accrue any benefit attributable to employer contributions under the plan, the individual is treated as an active participant even if no employee contribution is made and, thus, no benefit is accrued for the plan year.

Under a money purchase pension plan, an individual is an active participant if any employer contribution or forfeiture is required to be allocated to the individual's account with respect to the plan year ending with or within the individual's taxable year, even if the individual is not employed at any time during the plan year (e.g., contributions are continued on behalf of a permanently disabled employee (sec. 415(c)(3)(C)) or the individual's taxable year (e.g., the individual separates from service before the beginning of the taxable year).

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[3] See Reg. sec. 1.219-2.

An individual is treated as an active participant under a profit-sharing or stock bonus plan if any employer contribution is deemed added or any forfeiture is allocated to the individual's account during the individual's taxable year. A contribution is added to an individual's account on the later of the date the contribution is made or is allocated.

Finally, an individual is treated as an active participant for any taxable year in which the individual makes a voluntary or mandatory employee contribution. An individual is not treated as an active participant if earnings (rather than contributions or forfeitures) are allocated to the individual's account.

For purposes of the active participant rule, elective contributions (such as elective deferrals under a qualified cash or deferred arrangement) are treated as employer contributions.

The determination of whether an individual is an active participant or whether amounts are contributed on the individual's behalf is made without regard to whether the individual's rights to benefits under a plan are nonforfeitable.

Time for contributions

Under the Act, the prior-law rule relating to the time that contributions are required to be made is retained. Therefore, an individual may make IRA contributions for a taxable year up to the due date of the individual's tax return for the taxable year without extensions. Of course, as under prior law, the individual is required to designate the taxable year to which an IRA contribution relates when making the contribution.

Nondeductible contributions permitted to IRAs

In general

The Act permits individuals to make designated nondeductible IRA contributions to the extent that deductible contributions are not allowed due to the AGI phaseout. Thus, an individual may make nondeductible contributions to the extent of the excess of (1) the lesser of $2,000 ($2,250 in the case of a spousal IRA) or 100 percent of compensation over (2) the IRA deduction limit with respect to the individual.

In addition, the Act permits a taxpayer to elect to treat deductible IRA contributions as nondeductible. An individual might make such an election, for example, if the individual had no taxable income for the year after taking into account other deductions.

Under the Act, a designated nondeductible contribution means any contribution to an IRA for a taxable year that is designated as a nondeductible contribution in the manner prescribed by the Secretary. The designation is to be made on the individual's tax return for the taxable year to which the designation relates. As with deductible contributions, designated nondeductible contributions may be made up to the due date of the individual's tax return for the taxable year (without extensions).

An individual who files an amended return for a taxable year may change the designation of IRA contributions from deductible to nondeductible or vice versa. Such an amended return is to be treated as a return filed for the taxable year to which the return relates. Of course, under the usual rules, any increased tax liability that the individual may owe as a result of such a change in designation is to accompany the amended return.

Required information

An individual who makes a designated nondeductible contribution to an IRA for a taxable year or who receives a distribution from an IRA during a taxable year is required to provide such information as the Secretary may prescribe on the individual's tax return for the taxable year and, to the extent required by the Secretary, for succeeding taxable years (or on such other form that the Secretary may prescribe). The information that may be required includes, but is not limited to (1) the amount of designated nondeductible contributions for the taxable year, (2) the aggregate amount of designated nondeductible contributions for all preceding taxable years which have not previously been withdrawn, (3) the aggregate balance of all IRAs of the individual as of the close of the calendar year in which the taxable year begins,[4] and (4) the amount of distributions from IRAs during the taxable year.

If the required information is not provided on the individual's tax return for a taxable year (or other form prescribed by the Secretary), then all IRA contributions are presumed to have been deductible and, therefore, are taxable upon withdrawal from the IRA. The taxpayer can rebut this presumption with satisfactory evidence that the contributions were nondeductible.

IRA withdrawals

Amounts withdrawn from an IRA during a taxable year are includible in income for the taxable year under rules similar to the rules applicable to qualified plans under section 72. Under special rules applicable to IRAs for purposes of section 72, (1) all IRAs of an individual (including rollover IRAs and simplified employee pensions (SEPs), but excluding deductible qualified voluntary employee contributions) are treated as one contract, (2) all distributions that are made during a taxable year are treated as one distribution, (3) the value of the contract (calculated after adding back distributions that are made during the year), income on the contract, and investment in the contract are computed as of the close of the calendar year in which the taxable year begins,[5] and (4) the aggregate amount of withdrawals excludable from income for all taxable years shall not exceed the taxpayer's investment in the contract for all taxable years. Under this rule, a loss is not recognized until all the individual's IRA accounts are distributed.

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[4] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H.Con. Res. 395 which passed the House and the Senate in the 99th Congress.

[5] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H. Con. Res. 395 which passed the House and Senate in the 99th Congress.

The Act provides that, if an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the portion of the amount withdrawn which bears the same ratio to the amount withdrawn for the taxable year as the individual's income on the contract (including all IRA contributions) bears to the value of the contract (including both deductible and nondeductible contributions).

In the case of a withdrawal from an IRA, for purposes of the rules relating to withholding on pensions, annuities, and certain other deferred income, the payor is to assume that the amount withdrawn is includible in income. As under prior law, an individual may elect not to have tax withheld.

For example, assume that (1) an individual makes a $2,000 IRA contribution for the individual's 1987 tax year, $1,500 of which is deductible, (2) no withdrawals are made from the IRA during the taxable year, (3) the account balance at the end of the taxable year is $2,200, and (4) no prior IRA contributions have been made. The individual is required to report all such information on the individual's 1987 tax return. For 1988, assume (1) the individual makes a $2,000 IRA contribution to another IRA account, none of which is deductible, (2) no withdrawals are made from the IRA during the taxable year, and (3) the aggregate account balance at of the end of the taxable year for both IRAs is $4,600. In the individual's 1989 taxable year, no IRA contributions are made and $1,000 is withdrawn from the IRA to which the individual contributed during the 1987 taxable year. At the end of the 1989 taxable year, the aggregate account balance of both IRAs is $4,000. The $1,000 withdrawn from an IRA during the 1989 tax year is treated as partially a return of nondeductible contributions, calculated as the percentage of $1,000 that the investment in the contract ($500 plus $2,000) is of the value of the contract ($4,000) at the end of the taxable year plus distributions during the year ($1,000). Thus, $2,500/$5,000 or 1/2 of the $1,000 withdrawal is treated as a return of nondeductible contributions (and, therefore, is not taxable).

Overstatement of nondeductible contributions

Under the Act, an individual who overstates the amount of designated nondeductible contributions made for any taxable year is subject to a $100 penalty for each such overstatement unless the individual can demonstrate that the overstatement was due to reasonable cause.

Reporting requirement

The trustee of an IRA is required to report certain information to the Secretary and to the individuals for whom an IRA is maintained for each calendar year. This information is to include (1) contributions made to the IRA during the calendar year, (2) distributions from the IRA occurring during the calendar year, and (3) the aggregate account balance as of the end of the calendar year. This information is required to be reported by the January 31 following the end of the calendar year. In the case of a failure to report the required information, as under prior law, the penalty for the failure is $50 for each failure, unless it is shown that the failure is due to reasonable cause.

Spousal IRA deduction

Under the Act, the spousal IRA provision is amended to eliminate the requirement that the spouse have no compensation for the year in order to be eligible for the spousal IRA contribution. Therefore, under the Act, the spousal IRA is available either if (1) the spouse has no compensation for the taxable year, or (2) the spouse elects to be treated for the taxable year as having no compensation.

For purposes of this provision, if a spousal IRA deduction is claimed on a couple's tax return for the taxable year, the spouse for whom the deduction is claimed is deemed to have elected to be treated as having no compensation.

Qualified voluntary employee contributions

The Act repeals the deduction allowed for qualified voluntary employee contributions to qualified plans.

Acquisition of gold and silver coins

The Act exempts any gold or silver coin issued by the United States from the rules relating to IRA investment in collectibles.

Effective Dates

The provisions generally are effective for taxable years beginning after December 31, 1986. A taxpayer may make an IRA contribution for the 1986 taxable year up to the due date of the taxpayer's 1986 tax return (without extensions) under the prior-law IRA rules.

The nondeductible IRA provisions are effective for contributions and distributions in taxable years beginning after December 31, 1986.

The spousal IRA provision is effective for taxable years beginning before, on, or after December 31, 1985.

The repeal of the deduction for qualified voluntary employee contributions is effective for taxable years beginning after December 31, 1986. As under prior law, individuals may make such contributions for the 1986 calendar year if the contribution is made by April 15, 1987, or such earlier time as is provided by the plan.

The provision relating to acquisition of gold or silver coins by an IRA is effective for acquisitions after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $1,708 million in 1987, $4,962 million in 1988, $5,203 million in 1989, $5,694 million in 1990, and $6,207 million in 1991.

2. Qualified cash or deferred arrangements (secs. 1105 and 1116 of the Act and secs. 401(k), 402, and 4979 of the Code)[6]

Prior Law

In general

Under prior and present law, if a tax-qualified profit-sharing or stock bonus plan (or an eligible pre-ERISA money purchase pension plan) meets certain requirements described below (a "qualified cash or deferred arrangement"), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

Nondiscrimination requirements

Under prior and present law, special nondiscrimination tests apply a limit on elective deferrals that may be made by the group of highly compensated employees. This limit depends (in part) on the level of elective deferrals by nonhighly compensated employees. Under prior law, an employee was considered highly compensated, for this purpose, if the employee was one of the most highly compensated 1/3 of all employees eligible to defer under the arrangement. These nondiscrimination tests provided that the special treatment of elective deferrals was not available unless the cash or deferred arrangement did not disproportionately benefit highly compensated employees.

A cash or deferred arrangement met these special nondiscrimination requirements of prior law for a plan year if (1) the actual deferral percentage for the highly compensated employees was not greater than 150 percent of the actual deferral percentage for the other eligible employees, or (2) the actual deferral percentage for the highly compensated employees did not exceed the lesser of (a) the actual deferral percentage for the other eligible employees plus 3 percentage points or (b) 250 percent of the actual deferral percentage for the other eligible employees. In calculating these deferral percentages, contributions by the employer could be taken into account as elective deferrals by employees if they (1) were nonforfeitable when made, (2) satisfied the withdrawal restrictions applicable to elective deferrals, and (3) separately satisfied the general nondiscrimination rules (sec. 401(a)(4)).

Withdrawal restrictions

Under prior law, a participant in a qualified cash or deferred arrangement was not permitted to withdraw elective deferrals (and earnings thereon) prior to death, disability, separation from service, retirement, or (except in the case of a pre-ERISA money purchase pension plan) the attainment of age 59½ or the occurrence of a hardship. Under proposed regulations, an employee would be treated as having incurred a hardship only to the extent that the employee had an immediate and heavy bona fide financial need and did not have other resources reasonably available to satisfy the need.[7]

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[6] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 1102, 1111, and 1112; H.Rep. 99-426, pp. 685-694; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1205 and 1216; S.Rep. 99-313, pp. 547-559; and H.Rep. 99-841, Vol II (September 18, 1986), pp. 380-392 (Conference Report).

Limit on elective deferrals

Under present and prior law, elective deferrals under a qualified cash or deferred arrangement are subject to the overall limits on contributions to a defined contribution plan (sec. 415(c)). Thus, the sum of an employee's elective deferrals and any other annual additions on behalf of the employee under all defined contribution plans maintained by the employer generally cannot exceed the lesser of $30,000 or 25 percent of the participant's nondeferred compensation.

Reasons for Change

Congress was concerned that the rules relating to qualified cash or deferred arrangements under prior law encouraged employers to shift too large a portion of the share of the cost of retirement savings to employees. Congress was also concerned that the prior-law nondiscrimination rules permitted significant contributions by highly compensated employees without comparable participation by rank-and-file employees.

Congress recognized that individual retirement savings play an important role in providing for the retirement income security of employees. Congress also believed that excessive reliance on individual retirement savings (relative to employer-provided retirement savings) could result in inadequate retirement income security for many rank-and-file employees.

In particular, Congress believed that qualified cash or deferred arrangements should be supplementary retirement savings arrangements for employees; such arrangements should not be the primary employer-maintained retirement plan. Therefore, Congress believed that the extent to which employers can shift the burden of retirement saving to employees should be reduced. Moreover, Congress found it necessary to restrict the extent to which employers can condition the receipt of other benefits on employees' elections to defer under a qualified cash or deferred arrangement.

Another way of reducing the shifting of the burden of retirement savings to employees was to limit the number of employers that can maintain cash or deferred arrangements. Thus, Congress believed it was necessary to preclude the availability of qualified cash or deferred arrangements to State and local governments and tax-exempt employers.

In addition, Congress believed that the prior-law nondiscrimination rules for qualified cash or deferred arrangements permitted excessive tax-favored benefits for highly compensated employees without ensuring that there was adequate saving by rank-and-file employees. Because Congress believed that a basic reason for extending significant tax incentives to qualified pension plans was the delivery of comparable benefits to rank-and-file employees who may not otherwise save for retirement, Congress concluded that it was appropriate to revise the nondiscrimination rules for qualified cash or deferred arrangements in order to more closely achieve this goal.

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[7] Prop. Reg. sec. 1.401(k)-1(d)(2).

Finally, Congress believed that it was necessary to restrict the availability of hardship withdrawals under a qualified cash or deferred arrangement to ensure that the favorable tax treatment for retirement savings is limited to savings that are, in fact, used to provide retirement income.

Explanation of Provisions

Limit on elective deferrals

In general

Under the Act, the maximum amount that an employee can elect to defer for any taxable year under all cash or deferred arrangements in which the employee participates is limited to $7,000. This $7,000 limit is adjusted for inflation at the same time and in the same manner as the indexing of the dollar limit on benefits under section 415(d). The $7,000 limit applies to the employee's taxable year, regardless of the employer's taxable year or the plan year applicable to the cash or deferred arrangement.

Because, under the Act, the $7,000 limit applies only to elective deferrals, each employer may make additional contributions on behalf of any employee to the extent that such contributions, when aggregated with elective deferrals and after-tax contributions made by the employee under the employer's plans during the limitation year, do not exceed the limits on contributions and benefits (sec. 415).

Whether or not an employee has deferred more than $7,000 a year is determined without regard to any community property laws.

Unlike the limits on annual additions, which apply separately to amounts accumulated under plans of different employers, the $7,000 cap limits all elective deferrals by the employee. Thus, the $7,000 limit is coordinated with elective deferrals under simplified employee pensions (SEPs). In addition, the benefits under an unfunded deferred compensation plan of a State or local government or tax-exempt entity (sec. 457) and a plan described in section 501(c)(18) are coordinated with the limits on elective deferrals under a qualified cash or deferred arrangement or a SEP. Moreover, for purposes of determining an individual's cap on elective deferrals for a year, the $7,000 cap is reduced by the amount of the contributions made on behalf of an individual to a tax-sheltered annuity contract to the extent that the contributions are made pursuant to a salary reduction agreement. The $7,000 limit is also coordinated with elective deferrals under the Federal Thrift Savings Plan.

To ease the administrative burden on employees, employers, and the IRS, the elective deferral arrangements maintained by any single employer may preclude an employee from making elective deferrals under such arrangements for a taxable year in excess of $7,000.

Treatment of excess deferrals

If, for any taxable year, the total amount of elective deferrals contributed on behalf of an employee exceeds $7,000 to all qualified cash or deferred arrangements and other plans subject to the limit in which the employee participates, then the amounts in excess of $7,000 (the excess deferrals) are included in the employee's gross income for the taxable year to which the deferral relates. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the qualified cash or deferred arrangements and other plans subject to the limit in which the employee participates and notify the administrator of each plan of the portion of the excess deferrals allocated to that plan. Not later than April 15 after the close of the employee's taxable year, each plan may (but is not required to) distribute to the employee the amount of the excess deferrals (plus income attributable to the excess deferrals) allocated to the plan.

This distribution can be made notwithstanding any other provision of law. In addition, any distribution made prior to the close of the first plan year for which amendments are required to be made under the Act (see Part E.5., below) are to be treated as made in accordance with the provisions of the plan. Whether or not distributed, excess deferrals will not disqualify the plan or cash or deferred arrangement by virtue of being excess deferrals.

Excess deferrals (and earnings thereon) distributed by the required date are not subject to the additional income tax on early withdrawals from qualified plans (sec. 72(t)), or the 15-percent tax on excess distributions (sec. 4981A.)[8] Deferrals are not subject to the 10-percent excise tax on nondeductible contributions (sec. 4972) merely because they are excess deferrals. In addition, it is intended that a plan distributing excess deferrals is not to be required to obtain the consent of the participant or the consent of the participant's spouse with respect to the distribution of excess deferrals (and earnings thereon). Further, a distribution of excess deferrals is not to be treated as violating an outstanding qualified domestic relations order (within the meaning of sec. 414(p)).

Excess deferrals that are not distributed by the applicable April 15 date are not treated as employee contributions upon subsequent distribution even though such deferrals had been included in the employee's income. Thus, when subsequently distributed, such excess deferrals will be subject to any applicable income tax.

Whether or not distributed by the applicable April 15 date, excess deferrals are treated as elective deferrals for purposes of applying the special nondiscrimination test for qualified cash or deferred arrangements, except to the extent provided under rules prescribed by the Secretary. The Secretary is to prescribe rules preventing use of this rule to increase artificially the actual deferral percentage of nonhighly compensated employees.

The following example illustrates the application of the elective deferral limitation. Assume that, in 1987, employee A (whose taxable year is the calendar year) makes elective deferrals of $5,000 under employer X's qualified cash or deferred arrangement, and $3,000 under employer Y's qualified cash or deferred arrangement. For 1987, employee A may exclude from gross income only $7,000 of the total $8,000 of elective deferrals. The $1,000 excess deferral (plus income) may be withdrawn from X's plan or Y's plan, or partially from both plans. For example, A can request that $750 (plus income allocable to $750) be distributed from X's plan and that $250 (plus income allocable to $250) be distributed from Y's plan.

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[8] A technical correction may be needed so that the statute reflects this intent.

If either of the plans fails to make the requested distribution by April 15, 1988, then the excess deferrals are to remain in the qualified cash or deferred arrangement, subject to the general withdrawal restrictions applicable to elective deferrals under such arrangements. In addition, notwithstanding that A included the excess deferrals in gross income for 1987, A will not be treated as having any investment in the contract on account of the excess deferrals that were not distributed. Thus, the full amount of the excess deferrals not distributed will be included in income when actually distributed from the arrangement. Whether or not distributed by April 15, 1988, the excess deferrals are to be treated by X and Y as elective deferrals for purposes of applying the special nondiscrimination test for qualified cash or deferred arrangements, except to the extent provided under rules prescribed by the Secretary.

Any distribution of less than the entire amount of excess deferrals plus income attributable to such deferrals is treated as a pro rata distribution of excess deferrals and income. For example, assume an employee has excess deferrals of $1,000 and the income attributable to such deferrals is $100. By the applicable April 15 date, the plan distributes $1,000 to the employee; $909 is treated as a distribution of excess deferrals, and $91 is treated as a distribution of earnings. With respect to amounts remaining in the account, $91 is treated as an elective deferral and, because it was not distributed by the required date, will be subject to income tax upon distribution as well as in the year of deferral. Losses are allocated to excess deferrals in the same manner that income is allocated.

The employer's withholding obligations with respect to excess deferrals are determined in accordance with the generally applicable rules regarding withholding. Under these rules, if an employee has excess deferrals in a plan or plans of a single employer, then the employer will generally be liable for withholding and applicable penalties for failure to withhold because the employer will have reason to believe that the excess deferrals are includible in income. On the other hand, if the excess deferrals result solely because deferrals were made to plans of more than one employer, then the employer will generally not be liable for withholding or applicable penalties for failure to withhold, because the employer will not generally have reason to believe that the deferrals are includible in income. In any event, the employee may be liable for failing to make estimated tax payments as a result of excess deferrals.

Nondiscrimination requirements

In general

The Act modifies the special nondiscrimination test applicable to qualified cash or deferred arrangements by redefining the group of highly compensated employees and by modifying the special percentage tests.

Definition of highly compensated employees

The Act provides a uniform definition of highly compensated employees for purposes of the nondiscrimination rules for qualified plans and employee benefit plans. (See the description in Part B.7., below.)

Modification of nondiscrimination test

Under the Act, the special nondiscrimination test applicable to qualified cash or deferred arrangements is satisfied if the actual deferral percentage under a cash or deferred arrangement for eligible[9] highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual deferral percentage for all eligible nonhighly compensated employees plus 2 percentage points. Under the Act, if a cash or deferred arrangement satisfies the special nondiscrimination test, it is treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of deferrals. As under prior law, the employees eligible to participate in the arrangement are required to satisfy the provisions of section 410(b)(1).

Under the Act, if a highly compensated employee participates in more than 1 qualified cash or deferred arrangement of an employer, the employee's actual deferral percentage for purposes of testing each arrangement under the special nondiscrimination test is to be determined by aggregating the employee's elective deferrals under all of the arrangements of the employer.

The Act provides that, for purposes of applying the special nondiscrimination test, under rules prescribed by the Secretary, employer matching contributions that meet the vesting and withdrawal restrictions applicable to elective deferrals under a qualified cash or deferred arrangements and qualified nonelective contributions may be taken into account. It is intended that employers may take employer matching contributions and qualified nonelective contributions into account even though the Secretary has not prescribed rules relating to taking such contributions into account. Qualified nonelective contributions are defined to mean employer contributions (other than matching contributions) with respect to which (1) the employee may not elect to have the contributions paid to the employee in cash in lieu of being contributed to the plan and (2) the vesting and withdrawal restrictions applicable to elective deferrals under a qualified cash or deferred arrangement are satisfied. Employer matching contributions and qualified nonelective contributions do not meet the applicable withdrawal restrictions if such contributions (or earnings thereon) may be distributed on account of hardship.

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[9] A technical correction may be needed so that the statute reflects this intent.

In calculating the actual deferral percentages, an employee's compensation is determined in accordance with the new uniform definition of compensation (sec. 414(s), see Part B.1., below). In addition, for plan years beginning after December 31, 1988, compensation cannot exceed the new limit on includible compensation (sec. 401(a)(17), see Part D.1., below).

Excess contributions

If the special nondiscrimination rules are not satisfied for any year, the Act provides that the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. In addition, to the extent provided in regulations, instead of receiving an actual distribution of excess contributions, an employee may elect to have the excess contributions treated as an amount distributed to the employee and then contributed by the employee to the plan on an after-tax basis. Such recharacterization is not permitted in the absence of regulations. It is intended that such regulations will permit the plan to provide that the employee is required to make such an election as a condition of plan participation.

Distribution of the excess contributions may be made notwithstanding any provision of the plan until the first plan year for which plan amendments are required (see Part E.5., below) and notwithstanding any other provision of law. The amount distributed is not subject to the 10-percent additional income tax on early withdrawals (sec. 72(t)), or the 15-percent tax on excess distributions (sec. 4981A).[10] Contributions are not subject to the 10-percent tax on nondeductible contributions (sec. 4972) merely because they are excess contributions. In addition, Congress intended that a plan is not required to obtain the consent of the participant or the participant and spouse to distribute an excess contribution.

Excess contributions mean, with respect to any plan year, the excess of the aggregate amount of elective deferrals paid to the cash or deferred arrangement and allocated to the accounts of highly compensated employees over the maximum amount of elective deferrals that could be allocated to the accounts of highly compensated employees without violating the nondiscrimination requirements applicable to the arrangement. To determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed, the Act provides that the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentages beginning with those highly compensated employees with the highest actual deferral percentages. The excess contributions are to be distributed to those highly compensated employees for whom a reduction is made under the preceding sentence in order to satisfy the special nondiscrimination test.

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[10] A technical correction may be needed so that the statute reflects this intent.

The amount of income attributable to excess contributions is that portion of the income on the participant's account balance for the year that bears the same ratio to the total income as the excess contributions bear to the total account balance. As with excess deferrals, any distribution of less than the entire amount of excess contributions plus income attributable to such contributions is treated as a pro-rata distribution of excess contributions and income.

In addition, it is intended that the Secretary will prescribe rules relating to the coordination of an employee's excess deferrals (i.e., amounts in excess of the annual limit on elective deferrals) and the excess contributions and that, generally, the excess deferrals are to be calculated and distributed first and then the excess contributions are to be allocated among the highly compensated employees and distributed.

Excise tax on excess contributions

Under the Act, an excise tax is imposed on the employer making excess contributions to a qualified cash or deferred arrangement (sec. 4979). The tax is equal to 10 percent of the excess contributions (but not earnings on those contributions) under the arrangement for the plan year ending in the taxable year. However, the tax does not apply to any excess contributions that, together with income allocable to the excess contributions, are distributed or, in accordance with regulations prescribed by the Secretary, recharacterized as after-tax employee contributions no later than 2½ months after the close of the plan year to which the excess contributions relate.

Excess contributions (plus income) distributed or recharacterized within the applicable 2½-month period are to be treated as received and earned by the employee in the employee's taxable year in which the excess contributions, but for the employee's deferral election, would have been received as cash. For purposes of determining the employee's taxable year in which the excess contributions are includible in income, the excess contributions are treated as the first contributions made for a plan year. Of course, distributions of excess contributions (plus income) within the applicable 2½-month period are not taxed a second time in the year of distribution.

Withdrawal restrictions

In general

Under the Act, no withdrawals generally are permitted under a qualified cash or deferred arrangement prior to death, disability, separation from service, bona fide plan termination or (except in the case of a pre-ERISA money purchase pension plan) the attainment of age 59½. However, a cash or deferred arrangement (other than a pre-ERISA money purchase pension plan) may permit hardship withdrawals from elective deferrals (but not from income on the elective deferrals). For purposes of these rules, the prior-law definition of hardship continues to apply.

In addition, as described below, withdrawals may be made from a cash or deferred arrangement on account of certain corporate events. As under prior law, distributions from a pre-ERISA money purchase pension plan are not permitted on account of hardship or the attainment of age 59½.

Under the Act, employer matching contributions and qualified nonelective contributions (to the extent taken into account for purposes of the special nondiscrimination test) and income on such matching or nonelective contributions may not be distributed on account of hardship. Employer matching contributions and nonelective contributions not taken into account for purposes of the special nondiscrimination test are subject to the normal qualification rules relating to distributions. For example, employer matching contributions that are part of a profit-sharing plan and that are not taken into account for purposes of the special nondiscrimination test applicable to elective deferrals may be withdrawn after a stated number of years in excess of 2.

There is no special exception to the 10-percent additional income tax on early withdrawals (sec. 72(t)) for amounts distributed from a qualified cash or deferred arrangement. Thus, for example, amounts distributed from such an arrangement on account of hardship or due to termination of the arrangement are subject to the tax unless they meet one of the exceptions to the tax specified in section 72(t).

Withdrawals on account of plan termination, etc.

The Act permits distributions from a qualified cash or deferred arrangement upon (1) plan termination without the establishment of a successor plan; (2) the date of the disposition[11] by a corporation of substantially all of the assets (within the meaning of sec. 409(d)(2)) used by the corporation in a trade or business if the employee continues employment with the corporation acquiring the assets; or (3) the date of the disposition[12] by a corporation of the corporation's interest in a subsidiary (within the meaning of sec. 409(d)(3)) if the employee continues employment with the subsidiary. Under the Act, a distribution upon any of the 3 events described above is permitted only if it constitutes a total distribution of the employee's balance to the credit in the cash or deferred arrangement determined under the lump-sum distribution rules (but without regard to the requirements of clauses (i)-(iv) of sec. 402(e)(4)(A) and without regard to secs. 402(e)(4)(B) and (H)).[13]

Other restrictions

Conditioning other benefits on elective deferrals

Under the Act, a cash or deferred arrangement is not qualified if any contributions or benefits (other than matching contributions) are conditioned (either directly or indirectly) upon an employee's elective deferrals. Thus, elective deferrals under a qualified cash or deferred arrangement may not be taken into account for purposes of determining whether another plan meets the coverage requirements (sec. 410(b)), the general nondiscrimination rules (sec. 401(a)(4)), or other qualification rules. This provision does not apply for purposes of applying the average benefit percentage requirement (sec. 410(b)(2)(A)(ii)) under the coverage requirements (but does apply for purposes of the present-law classification requirement that is part of the average benefit test (sec. 410(b)(2)(A)(i)).

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[11] A technical correction may be needed so that the statute reflects this intent.

[12] A technical correction may be needed so that the statute reflects this intent.

[13] A technical correction may be needed so that the statute reflects this intent.

Under this rule, if an employee's participation in a defined benefit pension plan depends upon whether the employee makes elective deferrals under a cash or deferred arrangement, then the arrangement is not a qualified cash or deferred arrangement. Similarly, under the Act, a floor-offset defined benefit pension plan may not provide for offsets attributable to elective deferrals under a qualified cash or deferred arrangement.

In addition, a plan may not provide that voluntary after-tax employee contributions may not be made until an employee makes a specified amount of elective deferrals under a qualified cash or deferred arrangement. This provision also precludes the use of elective deferrals to satisfy the minimum contribution required on behalf of non-key employees in a top-heavy plan.

The prohibition on conditioning benefits on elective deferrals is not limited to benefits provided under a qualified plan. For example, the employer could not condition the availability of health benefits upon the employee's making elective deferrals under a cash or deferred arrangement.

Eligibility to participate

The Act provides that a qualified cash or deferred arrangement cannot require, as a condition of participation in the arrangement, that an employee complete a period of service greater than 1 year with the employer maintaining the plan. This special eligibility rule does not apply to employer matching and nonelective contributions, regardless of whether such contributions are used to satisfy the special nondiscrimination test.

For example, entitlement to an allocation of matching or nonelective contributions could be conditioned on 2 years of service (provided such contributions were nonforfeitable when made). In this example, employees with less than 2 years of service would be treated, for purposes of the special nondiscrimination test, in the same manner as employees with 2 years of service. Thus, if the matching contributions or nonelective contributions are used to satisfy the special test, the deferral percentage of employees with less than 2 years of service may be lower than that of employees with 2 years or more of service. Of course, if the matching contributions were used to satisfy the special test, in addition to being nonforfeitable, they would also have to satisfy the withdrawal restrictions applicable to elective deferrals. The matching or nonelective contributions also are required to meet the requirements of sections 401(a)(4) and 410.

Tax-exempt and State and local government employers

The Act prohibits tax-exempt organizations and State and local governments (or a political subdivision of a State or local government) from establishing qualified cash or deferred arrangements.

However, this restriction does not apply to a rural electric cooperative plan.

The Act provides that the prohibition does not apply to plans adopted before (1) May 6, 1986, in the case of an arrangement maintained by a State or local government (or political subdivision of a State or local government), or (2) July 2, 1986, in the case of an arrangement maintained by a tax-exempt organization. The grandfather treatment is limited to the employers who adopted the plan before the dates specified above. However, the grandfather treatment is not limited to employees (or classes of employees) covered by the plan as of the date the grandfather treatment is provided. Similarly, plans that are grandfathered may be amended in the future. Most such plans will, of course, have to be amended to take into account the new requirements relating to qualified cash or deferred arrangements. Other plan amendments may also be made. For example, a grandfathered plan may be amended in the future to provide for employer matching contributions or to modify the level of employer matching contributions.

Whether or not a tax-exempt organization continues to be an organization eligible for the grandfather treatment depends upon the facts and circumstances of each case. For example, if a tax-exempt organization is restructured or reorganized into a parent and a subsidiary organization (or other related organizations), the grandfather treatment generally would be available as long as the parent and subsidiary organizations (or other related organizations) are successor employers under the principles of section 414(a).

Solely for purposes of determining whether a plan was adopted before the dates specified for grandfather treatment of a plan maintained by a State or local government employer or a tax-exempt organization, an exception is to be provided to the normal requirement that a plan is not considered adopted until the trust that is part of the plan is created. Under this exception, a plan is to be considered adopted as of the date of formal approval by the governing body of the organization under a definite written plan that is binding upon the organization. The requirements of this exception are sufficient, but not necessary, to establish that a plan was adopted prior to the date specified for eligibility for grandfather treatment.

Effective Dates

Limit on elective deferrals

The provision relating to annual limits on elective deferrals generally is effective for taxable years beginning after December 31, 1986. A special effective date applies in the case of a plan maintained pursuant to a collective bargaining agreement with respect to contributions made pursuant to the agreement. The coordination of benefits under an unfunded deferred compensation plan of a State or local government or tax-exempt entity (sec. 457) with elective deferrals under qualified cash or deferred arrangements, simplified employee pensions, tax-sheltered annuities or plans described in section 501(c)(18) is effective for taxable years beginning after December 31, 1988.

Under a special transition rule, the provision limiting elective deferrals does not apply to elective deferrals of an employee made during 1987 and attributable to services performed during 1986 under a qualified cash or deferred arrangement if, under the terms of the arrangement in effect on August 16, 1986, (1) the employee's election to make the elective deferrals is made before January 1, 1987, and (2) the employer identifies the amount of the elective deferral before January 1, 1987.

The Act also contains a special rule for partnerships with fiscal years ending in calendar year 1987. Under this rule, in the case of the taxable year of a partnership which begins before January 1, 1987, and ends after January 1, 1987, elective deferrals are treated as having been made ratably during the taxable year.

Special nondiscrimination test

The provision relating to the special nondiscrimination test for a qualified cash or deferred arrangement is effective for years beginning after December 31, 1986. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Withdrawals and other restrictions

The provisions relating to withdrawals from qualified cash or deferred arrangements generally are effective for years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

However, the provision permitting withdrawals from a qualified cash or deferred arrangement on account of plan termination, a sale of assets, or a sale of a subsidiary is effective for distributions after December 31, 1984, even if the plan termination or sale occurred before December 31, 1984.

The provisions relating to conditioning other benefits on elective deferrals and eligibility to participate are effective for plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under a special rule, a cash or deferred arrangement will not be treated as violating the conditioning prohibition for plan years beginning before January 1, 1991, to the extent that the cash or deferred arrangement is part of a "qualified offset arrangement" with a defined benefit pension plan which offset arrangement was maintained by the employer on April 16, 1986.

Plans maintained by State or local governments

In the case of a qualified cash or deferred arrangement maintained by a State or local government that was adopted before May 6, 1986 (and is, therefore, eligible for the grandfather rule permitting the employer to maintain the arrangement), the following provisions in the Act applicable to qualified cash or deferred arrangements do not apply until years beginning after December 31, 1988: (1) the modification of the special nondiscrimination test, (2) the new definition of highly compensated employees, (3) the new definition of compensation, and (4) the rule aggregating only highly compensated employees (rather than all employees) for purposes of the special nondiscrimination test.

Revenue Effect

This provision and the provisions discussed in 3., 4., and 6. of this Part A are estimated to increase fiscal year budget receipts by $310 million in 1987, $628 million in 1988, $691 million in 1989, $809 million in 1990, and $924 million in 1991.

3. Nondiscrimination requirements for employer matching contributions and employee contributions (sec. 1117 of the Act and secs. 401(m) and 4979 of the Code)[14]

Prior Law

Under present and prior law, a qualified plan may permit employees to make after-tax contributions to a qualified plan. Employee contributions to a qualified plan may be voluntary or mandatory. Mandatory employee contributions include those made as a condition of obtaining employer-derived benefits (e.g., employee contributions made as a condition of obtaining employer matching contributions).

Present and prior law provide that a qualified plan may not discriminate in contributions and benefits in favor of employees who are officers, shareholders, or highly compensated. Under prior law, this nondiscrimination requirement was generally satisfied with respect to employee contributions if all participants were entitled to make contributions on the same terms and conditions. Voluntary employee contributions were permitted if all participants were eligible to make such contributions and if no employee was permitted to contribute more than 10 percent of compensation, determined based on cumulative contributions and cumulative compensation during the period of participation.

Reasons for Change

Congress was concerned that the rules relating to employer matching contributions and employee contributions under prior law encouraged employers to shift a greater share of the cost of retirement savings to employees. Congress was also concerned that the prior-law nondiscrimination rules permitted greater tax-favored contributions by or on behalf of highly compensated employees without comparable participation by rank-and-file employees. Accordingly, Congress concluded that it was appropriate to revise the nondiscrimination rules for employer matching contributions and employee contributions in order more closely to achieve this goal.

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[14] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1112; H.Rep. 99-426, pp. 694-698; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1217; S.Rep. 99-313, pp. 559-563; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 392-397 (Conference Report).

Explanation of Provisions

Special nondiscrimination test

In general

Under the Act, a special nondiscrimination test is applied to employer matching contributions and employee contributions under qualified defined contribution plans and employee contributions under a defined benefit pension plan (to the extent treated as contributions to a defined contribution plan (sec. 414(k)),[15] including employee contributions under a qualified cost-of-living arrangement (sec. 415(k)). This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. Contributions which satisfy the special nondiscrimination test are treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of contributions.

The term "employer matching contributions" means any employer contribution[16] made on account of (1) an employee contribution or (2) an elective deferral under a qualified cash or deferred arrangement or a tax-sheltered annuity contract.[17] Of course, forfeitures under a plan that are reallocated to participants' accounts on the basis of employee contributions or elective deferrals are also treated as matching contributions.

Employer matching contributions that are treated as elective deferrals for purposes of the special nondiscrimination test applicable to cash or deferred arrangements are not subject to the special test applicable to matching contributions and employee contributions, unless the employer elects otherwise.[18]

The special nondiscrimination test is satisfied for a plan year if the contribution percentage for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The contribution percentage for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

In calculating the contribution percentages, an employee's compensation is determined in accordance with the new uniform definition of compensation (sec. 414(s), see Part B. 1., below). In addition, for plan years beginning after December 31, 1988, the compensation taken into account for purposes of the special nondiscrimination test cannot exceed the new limit on includible compensation (sec. 401(a)(17), see Part D. 1., below).

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[15] A technical correction may be needed so that the statute reflects this intent.

[16] A technical correction may be needed so that the statute reflects this intent.

[17] A technical correction may be needed so that the statute reflects this intent.

[18] A technical correction may be needed so that the statute reflects this intent.

Required aggregation

If 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made are treated as a single plan for purposes of the coverage requirements for qualified plans (sec. 410(b)), then the plans are treated as a single plan for purposes of the special nondiscrimination test. In addition, if a highly compensated employee participates in 2 or more plans of an employer to which contributions subject to the special nondiscrimination test (sec. 401(m)) are made, then all such contributions made on behalf of the highly compensated employee are aggregated for purposes of the special nondiscrimination test.[19]

The Act also directs the Secretary to prescribe rules preventing multiple use of the second or alternative part of this special nondiscrimination test and of the special nondiscrimination test applicable to qualified cash or deferred arrangements. For this purpose, the alternative part of the special nondiscrimination tests is that part under which the tests are satisfied if the contribution percentage or actual deferral percentage for eligible highly compensated employees is no greater than the lesser of (1) 200 percent of the contribution percentage or actual deferral percentage for the eligible nonhighly compensated employees or (2) the contribution percentage or actual deferral percentage for the eligible nonhighly compensated employees plus 2 percentage points.

For example, assume an employer maintains one plan under which all employees are eligible. Under the plan, which contains a qualified cash or deferred arrangement, employees may elect to defer up to 5 percent of compensation and the employer will match those deferrals on a dollar-for-dollar basis. The matching contributions are subject to a 5-year vesting schedule. Under the cash or deferred arrangement, the actual deferral percentage of the eligible highly compensated employees is 4 percent and the actual deferral percentage of the nonhighly compensated employees is 2 percent. Thus, the cash or deferred arrangement satisfies the special nondiscrimination test, but does so only by fully using the alternative part of that test. The employer in this situation could not use the alternative part of the test with respect to the matching contributions under section 401(m). Instead, the contribution percentage of the eligible highly compensated employees under section 401(m) could not exceed 125 percent of the contribution percentage of the eligible nonhighly compensated employees. This rule could require the employer in this example to amend the plan to restrict the matching contributions to highly compensated employees or to distribute or forfeit the excess aggregate contributions.

Although the example provided above provides the clearest case of multiple use of the alternative test, there may be cases in which such multiple use is less clear. Thus, it is expected that the prohibition on multiple use of the alternative test is to be effective no earlier than the date specified in final regulations, which may relate back to the date of proposed regulations.

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[19] A technical correction may be needed so that the statute reflects this intent.

Permissive aggregation

Under the Act, under rules prescribed by the Secretary, an employer may elect to take into account elective deferrals, matching contributions treated as elective deferrals, and/or qualified nonelective contributions under the plan or under any other plan of the employer. Qualified nonelective contributions are defined to mean any employer contribution (other than a matching contribution) with respect to which (1) the employee may not elect to have the contribution paid to the employee in cash in lieu of being contributed to the plan, and (2) the vesting and withdrawal restrictions applicable to elective deferrals under qualified cash or deferred arrangements are satisfied. These withdrawal restrictions are not satisfied if hardship withdrawals of nonelective contributions (or earnings thereon) are permitted. The Secretary may prescribe such other conditions on aggregating types of contributions for nondiscrimination purposes as are appropriate to carry out the intent of the provisions. (Of course, matching contributions that are treated as elective deferrals are required to be nonforfeitable and must satisfy the withdrawal restrictions applicable to elective deferrals.)

For example, if an employer maintains a qualified cash or deferred arrangement, a plan to which after-tax employee contributions and matching contributions are made, and a profit-sharing plan with employer contributions that are qualified nonelective contributions, then, subject to the rule described below, the employer can elect, for purposes of the special nondiscrimination test for matching contributions and employee contributions, to aggregate (1) elective deferrals under the qualified cash or deferred arrangement, (2) after-tax employee contributions, (3) employer matching contributions, or (4) qualified nonelective contributions. Of course, the employer could elect to aggregate so much of such elective deferrals, etc., as are necessary to satisfy the special nondiscrimination test.

Elective deferrals, matching contributions treated as elective deferrals, or qualified nonelective contributions may only be taken into account for purposes of the special nondiscrimination rules if the deferrals or contributions taken into account satisfy the applicable nondiscrimination rules and other contributions would not fail to satisfy applicable nondiscrimination rules if the deferrals or contributions taken into account were disregarded.

For example, assume an employer maintains 2 plans, each of which covers all employees. One plan contains a qualified cash or deferred arrangement. This plan does not provide for matching contributions but does provide a 2-percent qualified nonelective contribution on behalf of the nonhighly compensated employees. The second plan provides matching contributions for employees who make employee contributions. Assume further that, under the cash or deferred arrangement, the actual deferral percentage for the highly compensated employees is 4 percent while the actual deferral percentage for the nonhighly compensated employees, without regard to the qualified nonelective contribution, is 1 percent.

With the qualified nonelective contribution taken into account for purposes of the special nondiscrimination test applicable to elective deferrals, the respective actual deferral percentages are 4 percent and 3 percent. These percentages satisfy the special nondiscrimination test. In fact, the actual deferral percentage for the nonhighly compensated employees could have been 2 percent and still satisfied the special test. Thus, the nonelective contribution could have been 1 percent instead of 2 percent. The extra 1 percent nonelective contribution, not needed for purposes of the cash or deferred arrangement special nondiscrimination test, may be used to help the other plan satisfy the special test applicable to matching contributions and employee contributions. However, the full 2 percent nonelective contribution may not be used to help the other plan because half of it is needed so that the cash or deferred arrangement satisfies the special test applicable to it.

If the rate of matching contributions favors the highly compensated employees (e.g., because there is a higher rate of matching contributions on elective deferrals or employee contributions in excess of a certain amount and because the highly compensated employees make proportionately more elective deferrals or employee contributions above that amount), then the general nondiscrimination requirements of section 401(a)(4) are violated even if the special nondiscrimination test is satisfied. This rule applies regardless of whether the rate of matching contributions favors the highly compensated employees expressly under the plan formula or by virtue of the fact that highly compensated employees receive matches on excess deferrals, excess contributions, or excess aggregate contributions.

On the other hand, a plan is not treated as automatically violating the general nondiscrimination requirements (sec. 401(a)(4)) merely because (1) employer matching contributions are made both with respect to elective deferrals and with respect to employee after-tax contributions and (2) the highly compensated employees generally make more after-tax employee contributions.

Eligible employees

Under the Act, any employee who is eligible to make an employee contribution (or, if the employer takes elective deferrals into account, is eligible to make elective deferrals) or is eligible to receive a matching contribution that is subject to this special nondiscrimination test (sec. 401(m)) is treated as an eligible employee for purposes of the special nondiscrimination test. In addition, under the Act, if an employee contribution (or elective deferral, if applicable) is required as a condition of participation in a plan, an employee who is eligible to participate, but fails to make a required contribution, is treated as an eligible employee on behalf of whom no contributions are made.

Definition of highly compensated employee

The Act modifies the definition of highly compensated employees to which the special nondiscrimination test applies and provides that this uniform definition applies generally for purposes of the nondiscrimination requirements for qualified plans and employee benefit programs (see the description in Part B.7., below).

Treatment of excess aggregate contributions

As under the provision of the Act relating to qualified cash or deferred arrangements, if the special nondiscrimination test is not satisfied for any year, the plan will not be disqualified if the excess aggregate contributions (plus income allocable to such excess aggregate contributions) are distributed before the close of the following plan year. Generally, the amount of excess aggregate contributions and their allocation to highly compensated employees is determined in the same manner as with respect to excess contributions.

Under the Act, the amount of income attributable to excess aggregate contributions is that portion of the income on the participant's account balance for the year that bears the same ratio as the excess aggregate contributions bear to the total account balance.

In addition, Congress intended that the Secretary will prescribe rules relating to the coordination of an employee's excess deferrals (i.e., amounts in excess of the annual limit on elective deferrals under a qualified cash or deferred arrangement), the excess contributions, and the excess aggregate contributions. Generally, the excess deferrals are to be calculated and distributed first, then the excess contributions are to be allocated among the highly compensated employees and distributed and, finally, the excess aggregate contributions are to be allocated among highly compensated employees and distributed.

Distribution of excess aggregate contributions may be made notwithstanding any other provision of law, and the amount distributed is not subject to the additional income tax on early withdrawals (sec. 72(t)) or the 15-percent tax on excess distributions (sec. 4981A).[20] Contributions are not subject to the 10-percent tax on nondeductible contributions (sec. 4972) merely because they are excess aggregate contributions. In addition, Congress intended that a plan is not required to obtain the consent of the participant or the participant and spouse to distribute an excess aggregate contribution.

Also, the Act provides that a plan can distribute excess aggregate contributions without regard to the terms of the plan until the first plan year for which plan amendments are required (see Part E.5., below).[21]

A plan may designate whether excess contributions or excess aggregate contributions are attributable to elective deferrals, qualified nonelective contributions, employee contributions, or employer matching contributions, as long as the ordering designated by the plan is used consistently. Of course, the plan's designation is also subject to the requirement that the order in which amounts are to be calculated and distributed is excess deferrals, excess contributions, and excess aggregate contributions. Further, a plan may not designate an order of distributions that results in the plan violating the general nondiscrimination requirements (sec. 401(a)(4)).

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[20] A technical correction may be needed so that the statute reflects this intent.

[21] A technical correction may be needed so that the statute reflects this intent.

Excise tax on excess aggregate contributions

Under the Act, an excise tax is imposed on the employer with respect to excess aggregate contributions (sec. 4979). The tax is equal to 10 percent of the excess aggregate contributions (but not earnings on those contributions) under the plan for the plan year ending in the taxable year.

However, the tax does not apply to any excess aggregate contributions that, together with income allocable to the excess aggregate contributions, are distributed (or, if nonvested, forfeited) no later than 2-1/2 months after the close of the plan year in which the excess aggregate contributions arose.

Excess matching contributions (plus income), excess elective deferrals (plus income), excess qualified nonelective contributions (plus income) and income on excess employee contributions distributed within the applicable 2-1/2 month period are to be treated as received and earned by the employee in the employee's taxable year to which such excess aggregate contributions relate. Excess matching contributions are deemed to relate to the same taxable year to which the employee's mandatory contribution relates, i.e., mandatory contributions that are elective deferrals relate to the taxable year in which the employee would have received (but for the deferral election) the deferral as cash, and mandatory contributions that are employee contributions relate to the taxable year of contribution. For purposes of this rule, the first contributions (of the type distributed) for a plan year are deemed to be excess aggregate contributions.

Effective Dates

The provisions generally are effective for plan years beginning after December 31, 1986. A special effective date applies to plans maintained pursuant to a collective bargaining agreement. In the case of a tax-sheltered annuity, the provisions are generally effective for plan years beginning after December 31, 1988, with a special effective date for tax-sheltered annuities maintained pursuant to a collective bargaining agreement.[22]

Revenue Effect

This provision and the provisions discussed in 2., 4., and 6. of this Part A are estimated to increase fiscal year budget receipts by $310 million in 1987, $628 million in 1988, $691 million in 1989, $809 million in 1990, and $924 million in 1991.

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[22] A technical correction may be needed so that the statute reflects this intent.

4. Unfunded deferred compensation arrangements of State and local governments (sec. 1107 of the Act and sec. 457 of the Code)[23]

Prior Law

Constructive receipt

Under prior and present law, a taxpayer using the cash receipts and disbursements method of accounting generally is not required to include compensation in income until it is actually or constructively received (sec. 451). Under the doctrine of constructive receipt, a taxpayer ordinarily will be deemed to have received income if the taxpayer had a right to receive that income and the exercise of that right is not subject to substantial restrictions (Treas. reg. sec. 1.451-2(a)).

In applying the doctrine of constructive receipt, a number of courts have held that when a taxpayer enters into an agreement with a payor to receive compensation on a deferred basis, rather than currently, the taxpayer generally would not be in constructive receipt of that compensation so long as the agreement is made before the taxpayer obtained an unqualified and unconditional right to the compensation.[24]

On February 3, 1978, the Internal Revenue Service issued proposed regulations that provided generally that, if payment of an amount of a taxpayer's fixed basic or regular compensation was deferred at the taxpayer's individual election to a taxable year later than that in which the amount would have been payable but for the election, then the deferred amount would be treated as received in the earlier taxable year.[25] These proposed regulations would have applied to plans maintained by taxable employees, State and local governments, and nongovernmental tax-exempt organizations.

In the Revenue Act of 1978, Congress exempted from the scope of the proposed regulations compensation deferred under an unfunded deferred compensation plan maintained by a taxable employer. Under the 1978 Act, the year that deferred compensation was to be included in gross income under certain private deferred compensation plans was determined under the principles set forth in the rulings, regulations, and judicial decisions relating to deferred compensation that were in effect on February 1, 1978.

The 1978 Act also exempted from the scope of the proposed regulations certain unfunded deferrals under an eligible deferred compensation plan of a State or local government (sec. 457). Certain tax-exempt rural electric cooperatives were also eligible for this exemption. Under prior law, there was no specific statutory provision governing deferred compensation arrangements of nongovernmental tax-exempt organizations.

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[23] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1104; H.Rep. 99-426, pp. 698-702; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1207; S.Rep. 99-313, pp. 563-566; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 397-400 (Conference Report).

[24] See *Goldsmith* v. *United States*, 586 F.2d 810 (Ct. Cl. 1978); *James F. Oates*, 18 T.C. 570 (1952); aff'd, 207 F.2d 711 (7th Cir. 1953); acq. (and prior nonacq. withdrawn) 1960-1 C.B. 5; *Howard Veit*, 8 T.C. 809 (1947), acq. 1947-2 C.B. 4; cf. *Kay Kimbell*, 41 B.T.A. 940 (1940), acq. and nonacq. 1940-2 C.B. 5, 12; J.D. *Amend*, 13 T.C. 178 (1949), acq. 1950-1 C.B. 1; *James Gould Cozzens*, 19 T.C. 663 (1953); *Howard Veit*, 8 CCH Tax Ct. Mem. 919 (1949). See, also, Rev. Rul. 60-31, 1960-1 C.B. 174.

[25] Prop. reg. sec. 1.61-16.

Eligible unfunded deferred compensation plan

Under an eligible unfunded deferred compensation plan of a State or local government, amounts of current compensation that are deferred on behalf of an employee are included in gross income when they are paid or made available. Under present and prior law, the maximum annual deferral under such a plan is the lesser of (1) $7,500, or (2) 33⅓ percent of compensation (net of the deferral). Amounts contributed to a tax-sheltered annuity (both elective and nonelective) are taken into account in calculating whether an employee's deferrals exceed the limits.

In general, under prior law, amounts deferred under an eligible deferred compensation plan could not be made available to an employee before separation from service with the employer or an unforeseeable emergency. Distributions under the plan were required to commence no later than 60 days after the close of the later of (1) the year in which the employee attained the normal retirement age under the plan or (2) the year in which the employee separated from service. Amounts that were made available to an employee upon separation from service were includible in gross income in the taxable year in which they were made available.

Under an eligible deferred compensation plan, distributions are required to be made primarily for the benefit of participants, rather than beneficiaries. If a participant's benefits commence prior to death, the total amount of payments scheduled to be made to the participant are required to be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary.

Under an eligible plan, if a participant died before the date the entire amount deferred had been paid out, the entire amount deferred (or the remaining portion thereof, if payment commenced before death) was required to be paid to the participant's beneficiary over a period not exceeding 15 years, unless the beneficiary was the participant's surviving spouse. If the beneficiary was the participant's surviving spouse, benefits were required to be paid over the life of the surviving spouse or any shorter period.

Under prior and present law, deferrals under any plan, agreement, or arrangement that is not an eligible deferred compensation plan (other than a qualified State judicial plan, a qualified plan, or a tax-sheltered annuity) are includible in an employee's gross income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether constructive receipt has taken place.

Reasons for Change

If adopted, the 1978 proposed regulations would prohibit employees of tax-exempt organizations from participating in unfunded deferred compensation plans as a means of providing tax-deferred retirement income. Congress believed that it was inappropriate to apply constructive receipt principles to employees of nongovernmental tax-exempt entities, thereby precluding their ability to establish deferred compensation arrangements on a salary reduction basis, while permitting salary reductions for certain employees of governments and taxable entities. Congress also believed it was appropriate to impose limits on the amount of compensation that may be deferred under an arrangement maintained by a nongovernmental tax-exempt employer. In the case of a nongovernmental tax-exempt entity, as in the case of a State and local government, the usual tension between an employee's desire to defer tax on compensation and the employer's desire to obtain a current deduction for compensation paid is not present. Accordingly, Congress determined that unfunded deferred compensation plans should be available to employees of nongovernmental tax-exempt organizations on the same basis as they are made available to employees of State and local governments.

Congress was concerned that the prior-law rules relating to the distribution of benefits under an eligible plan permitted deferred compensation under such an arrangement to accumulate on a tax-favored basis for too long a period. Accordingly, Congress believed that more restrictive distribution rules should be imposed on unfunded deferred compensation plans to ensure that tax-favored savings are used primarily for retirement purposes.

Explanation of Provisions

Application to tax-exempt employers

The Act applies the limitations and restrictions applicable to eligible and ineligible unfunded deferred compensation plans of State and local governments to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations. For this purpose, an international organization that is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669) is considered a governmental organization. In addition, the Act (1) requires that amounts deferred by an employee under a qualified cash or deferred arrangement, an elective SEP, or a section 501(c)(18) plan, be taken into account in determining whether the amounts deferred on behalf of an employee under an eligible deferred compensation plan exceed the limits on deferrals under the plan; (2) modifies the distribution requirements applicable to eligible deferred compensation plans; (3) permits transfers between eligible deferred compensation plans; (4) modifies the rule that an employee is taxable on deferrals under an eligible plan when such amounts are made available; and (5) provides that amounts deferred under an eligible deferred compensation plan are treated as elective contributions under a tax-sheltered annuity for purposes of the special catch-up election.

The Act does not change the status of section 457 plans for purpose of Title I of ERISA. Also, section 457 continues to apply to the same types of deferred compensation to which it applied under prior law.

Distribution requirements

The Act modifies the distribution requirements for eligible deferred compensation plans maintained by State and local governments and nongovernmental tax-exempt entities. The Act also provides that employees under an eligible deferred compensation plan are subject to the required beginning date and minimum required distribution rules applicable to qualified plans (sec. 401(a)(9)), in addition to the special distribution rules applicable under section 457. With respect to the rule under section 457 prohibiting distributions prior to separation from service or unforeseen emergencies, an exception is provided for distributions in or after the year in which the employee attains age 70½.[26]

Under the special distribution rules in section 457, as modified, distributions commencing prior to the death of a participant under an eligible deferred compensation plan are required to satisfy a payout schedule under which benefits projected to be paid over the lifetime of the participant are at least 66⅔ percent of the total benefits payable with respect to the participant.

If the participant dies prior to the date that the participant's entire interest has been distributed, or if the participant dies prior to commencement of the distribution of benefits, the Act requires that payments to the participant's beneficiary commence within 60 days of the close of the plan year in which the participant's death occurs.

In the case of a distribution beginning before the death of the participant, any amount not distributed to the participant during the participant's life is to be distributed at least as rapidly as under the method of distribution being used as of the participant's death. If the participant dies before distributions commence, the entire amount deferred is to be distributed over a period not in excess of 15 years, unless the beneficiary is the participant's surviving spouse. If the beneficiary is the participant's surviving spouse, payments are to be made over the life expectancy of the surviving spouse or any shorter period.

Whenever distributions (pre- or post-death) are to be made over a period extending beyond 1 year, the Act requires that the distributions be made in substantially nonincreasing periodic payments no less frequently than annually. This requirement will not apply, however, to distributions made for a period during which no distributions are required.

Constructive receipt

The Act provides that benefits are not treated as made available under an eligible deferred compensation plan merely because an employee is allowed to elect to receive a lump-sum payment within 60 days of the election. However, the 60-day rule only applies if the employee's total deferred benefit does not exceed $3,500 and no additional amounts may be deferred with respect to the employee.

Transfers

The Act permits the transfer of benefits between eligible deferred compensation plans under certain circumstances. Thus, for example, benefits may be transferred from one eligible plan to another within a State or to another eligible plan in a different State.

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[26] A technical correction may be needed so that the statute reflects this intent.

State judicial plans

The Act exempts from the new requirements for eligible deferred compensation plans any qualified State judicial plan (as defined in sec. 131(c)(3)(B) of the Revenue Act of 1978, as amended by sec. 252 of the Tax Equity and Fiscal Responsibility Act of 1982).

Effective Dates

The provision extending the eligible deferred compensation plan rules to tax-exempt employers is effective for taxable years beginning after December 31, 1986. The Act provides that a plan maintained by a tax-exempt organization that does not meet the requirements for treatment as an eligible deferred compensation plan is immediately treated as not meeting such requirements without regard to notification by the Secretary or a grace period.

The modifications to the distribution requirements applicable to eligible deferred compensation plans generally are effective for taxable years beginning after December 31, 1988. However, the provisions (1) permitting transfers between eligible deferred compensation plans and (2) permitting certain benefits to be made available without constructive receipt are effective with respect to transfers or amounts made available in years beginning after December 31, 1986.

Under the Act, section 457 does not apply to amounts deferred under a plan established by a tax-exempt employer with respect to an employee which (1) were deferred for taxable years beginning before January 1, 1987, or (2) are deferred for taxable years beginning after December 31, 1986, pursuant to an agreement between the employer and the employee that (a) was in writing on August 16, 1986, and (b) on August 16, 1986, provided for a deferral for each taxable year of a fixed amount or an amount determined pursuant to a fixed formula. This exception does not apply with respect to amounts deferred in a fixed amount or under a fixed formula (including a fixed formula under a plan that is in the nature of a defined benefit plan) for any taxable year ending after the date on which the amount or formula is modified after August 16, 1986. This grandfather treatment applies to all deferred compensation plans of tax-exempt employers without regard to whether they would be eligible deferred compensation plans within the meaning of section 457.[27]

For purposes of the grandfather rule, amounts are considered deferred from a taxable year if, but for the deferral, they would have been paid in that year. In the case of a grandfathered plan that is in the nature of a defined benefit plan, deferrals of amounts that are allocable to taxable years of the individual are to be treated as compensation that would have been paid or made available in such taxable years (but for the deferred compensation plan). A plan may also be grandfathered if it provides for deferrals over a stated period of time rather than allocable to any specific taxable year. (Of course, the grandfather rule requiring that the deferral amount or formula be fixed on August 16, 1986, applies.)

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[27] A technical correction may be needed so that the statute reflects this intent.

In applying the limits to a deferral not grandfathered, grandfathered amounts are taken into account.

The Act provides a special rule with respect to certain deferred compensation plans. Under this special rule, the provisions do not apply, solely with respect to deferrals under the plan, (1) to employees on August 16, 1986, of a nonprofit corporation organized under the laws of the State of Alabama maintaining a deferred compensation plan with respect to which the Internal Revenue Service issued a ruling dated March 17, 1976, that the plan would not affect the tax-exempt status of the organization, or (2) to individuals participating on August 16, 1986, in a deferred compensation plan with respect to which a letter dated November 6, 1975, submitted the original plan to the Internal Revenue Service, an amendment was submitted on November 19, 1975, and the Internal Revenue Service responded with a letter dated December 24, 1975.[28]

Revenue Effect

This provision and the provisions discussed in 2., 3., and 6. of this Part A are estimated to increase fiscal year budget receipts by $310 million in 1987, $628 million in 1988, $691 million in 1989, $809 million in 1990, and $924 million in 1991.

5. Deferred annuity contracts (secs. 1123 and 1135 of the Act and secs. 72(q) and 72(u) of the Code)[29]

Prior Law

Under prior law, income credited to a deferred annuity contract was not currently includible in the gross income of the owner of the contract nor was the income taxed to the insurance company issuing the contract. In general, under prior and present law, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. In addition, a portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

Prior and present law provide an additional income tax on certain early withdrawals under an annuity contract. Under prior law, amounts withdrawn from an annuity contract before the owner of the contract attained age 59½, died, or became disabled were subject to an additional income tax equal to 5 percent of the amount of the withdrawal includible in income. This additional tax was not imposed if the distribution (a) was one of a series of substantially equal periodic payments made for the life of the taxpayer or over a period extending for at least 60 months after the annuity starting date, or (b) was allocable to investment in the contract before August 14, 1982.

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[28] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H.Con. Res. 395 which passed the House and Senate in the 99th Congress.

[29] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1135; H.Rep. 99-426, pp. 703-705; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1234; S.Rep. 99-313, pp. 566-569; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 400-404 (Conference Report).

Reasons for Change

Congress believed that the prior-law rules relating to deferred annuity contracts presented an opportunity for employers to fund, on a tax-favored basis, significant amounts of deferred compensation for employees. This favorable tax treatment created a disincentive for employers to provide benefits to employees under qualified pension plans, which are subject to significantly greater restrictions. In addition, because deferred annuity contracts could be provided to a limited class of employees, rather than to employees generally (as is required in the case of a qualified pension plan), Congress was concerned that the prior-law treatment of deferred annuity contracts diluted the effect of the nondiscrimination rules applicable to qualified pension plans.

Further, Congress believed that tax incentives for savings should not be provided unless the savings generally are held for retirement. Other forms of tax-favored savings (e.g., IRAs) are subject to higher additional taxes on early withdrawals. In general, Congress believed that the additional income tax on early withdrawals should be the same for all tax-favored retirement savings arrangements and should be increased so that the additional tax serves, in most cases, to recapture a significant portion of the benefits of deferral of tax on income.

Explanation of Provisions

Income on the contract

Under the Act, if any annuity contract is held by a person who is not a natural person (such as a corporation), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year.

In the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person. For example, if an employer holds a group policy to satisfy State group policy requirements, but has no right to any amounts contributed to the contract and all amounts contributed are employee contributions, the employer is merely the nominal holder of the contract and the contract is not treated as held by a nonnatural person.

Income on the contract means the excess of (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract for all years, over (2) the investment in the contract (i.e., the aggregate amount of premiums paid under the contract minus policyholder dividends or the aggregate amounts received under the contract that have not been included in income).

The provision does not apply to any annuity contract that (1) is acquired by the estate of a decedent by reason of the death of the decedent; (2) is held under a qualified plan (sec. 401(a) or 403(a)), as a tax-sheltered annuity (sec. 403(b)) or under an IRA; (3) is a qualified funding asset for purposes of a structured settlement agreement (as defined in sec. 130(d), but without regard to whether there is a qualified assignment); (4) is purchased by an employer upon the termination of a qualified plan and is held by the employer until the employee's rights under the contract are satisfied;[30] or (5) is an immediate annuity.

Under the exception for an annuity which constitutes a qualified funding asset, an exception is provided for (1) qualified funding assets purchased by structured settlement companies, and (2) annuity contracts (which otherwise meet the definition of a qualified funding asset) purchased and held directly by a property or casualty insurance company to fund periodic payments for damages.

An immediate annuity is defined as an annuity (1) which is purchased with a single premium or consideration, and (2) the annuity starting date of which commences no later than 1 year from the date of purchase of the annuity. In determining whether an annuity is an immediate annuity contract, the normal rules (sec. 72(c)(4)) apply to define the annuity starting date. Thus, the annuity starting date is the first day of the first period for which an amount is received as an annuity, whether or not payment is actually made on that date.

The treatment of annuity contracts held by nonnatural persons applies generally for purposes of subtitle A of Title I of the Internal Revenue Code of 1986, other than subchapter L.[31]

Early withdrawal tax

Under the Act, the early withdrawal tax on deferred annuities is increased from 5 to 10 percent to conform to the new additional income tax on early withdrawals from qualified plans and other tax-favored retirement arrangements. In addition, the Act modifies the circumstances under which the early withdrawal tax is imposed.

Under the Act, the tax does not apply to any distribution (1) made after the taxpayer attains age 59½, (2) made after the death of the holder,[32] (3) attributable to the taxpayer's becoming disabled, (4) which is part of a series of substantially equal periodic payments (not less frequently than annually) made over the life or life expectancy of the taxpayer or the lives or life expectancies of the taxpayer and the taxpayer's beneficiary, (5) from a qualified plan or other plan described in section 72(e)(5)(D), (6) allocable to investment in the contract before August 14, 1982, (7) under a qualified funding asset (within the meaning of sec. 130(d), but without regard to whether there is a qualified assignment), (8) under an immediate annuity contract, or (9) under a contract which is purchased by an employer upon termination of a plan described in section 401(a) or 403(a) and which is held by the employer until such time as the employee separates from service.

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[30] A technical correction may not be needed so that the statute reflects this intent.

[31] A technical correction may be needed so that the statute reflects this intent.

[32] The technical corrections provisions of the Act clarify the applicability of the additional income tax on early withdrawals in the case of the holder's death.

If distributions to an individual are not subject to the tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed if the individual changes the distribution method prior to age 59½ to a method which does not qualify for the exception. The additional tax will be imposed in the first taxable year in which the modification is made and will be equal to the tax (as determined under regulations) that would have been imposed had the exception not applied. For example, if, at age 50, an individual begins receiving payments under a distribution method which provides for substantially equal payments over the individual's life expectancy, and, at age 58, the individual elects to receive the remaining benefits in a lump sum, the additional tax will apply to the lump sum and to amounts previously distributed.

In addition, the recapture tax will apply if an individual does not receive payments under a method that qualifies for the exception for at least 5 years, even if the method of distribution is modified after the individual attains age 59½. Thus, for example, if an individual begins receiving payments in substantially equal installments at age 56, and alters the distribution method to a form that does not qualify for the exception prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59½ as if the exception had not applied. The additional tax will not be imposed on amounts distributed after attainment of age 59½.

Effective Dates

The provision eliminating the favorable tax treatment of annuities held by nonnatural persons is effective for contributions to annuity contracts after February 28, 1986.

The provision modifying the early withdrawal tax applicable to deferred annuities is effective for taxable years beginning after December 31, 1986.

The Act contains an exception from the early withdrawal tax for individuals who, as of March 1, 1986, commenced receiving annuity payments pursuant to a written election designating a specific schedule for the payment of the annuity (without regard to whether the individual is an employee who separated from service with an employer),[33] provided the form of distribution would not have been subject to the early withdrawal tax under prior law.[34] The requirement that benefits be paid pursuant to a written election designating a specific schedule will be deemed satisfied if the contract from which the benefits are paid provides for only one form of distribution, or if (1) the contract provides that, in the absence of an election to the contrary, an individual will be paid benefits according to the automatic form of payment specified in the contract, and (2) the individual is, in fact, receiving payments in that form.

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[33] A technical correction may be needed so that the statute reflects this intent.

[34] A technical correction may be needed so that the statute reflects this intent.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $3 million in 1987, $12 million in 1988, $27 million in 1989, $41 million in 1990, and $52 million in 1991.

6. Elective contributions under tax-sheltered annuities (sec. 1105 of the Act and sec. 402 of the Code)[35]

Prior Law

Under prior and present law, public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax-sheltered annuity contract (sec. 403(b)). Payments to a custodial account investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted.

The amount paid by the employer is excluded from the employee's income for the taxable year to the extent the payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity (sec. 403(b)(2)). Under prior law, no separate limit applied to an employee's elective deferrals under a tax-sheltered annuity or custodial account.

Under present and prior law, employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans (sec. 415). Because tax-sheltered annuities generally are defined contribution plans, the limit on the annual additions on behalf of an employee generally is the lesser of 25 percent of compensation or $30,000. Certain catch-up elections allow an employer to contribute in excess of the usual percentage limits in certain years.

Reasons for Change

Congress was concerned that the prior-law rules relating to tax-sheltered annuity programs were inequitable because individuals whose employers make contributions to a tax-sheltered annuity on their behalf under a salary reduction agreement could elect to save up to $30,000 a year. On the other hand, an individual who was employed by a tax-exempt organization that did not offer a salary reduction arrangement was limited to a $2,000 IRA contribution. One way of reducing the extent to which this inequity occurs was to reduce the limits on contributions to a tax-sheltered annuity made pursuant to a salary reduction agreement.

Further, Congress believed that, in addition to limiting the amount that could be saved on a salary reduction basis, it was necessary to ensure that employees have equal access to tax-sheltered annuities through salary reduction agreements.

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[35] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1102; H.Rep. 99-426, pp. 705-708; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 404-406 (Conference Report).

Explanation of Provisions

Limit on elective deferrals

The Act imposes a limit on elective deferrals under a tax-sheltered annuity which operates in the same manner as the limit on elective deferrals under a qualified cash or deferred arrangement. However, the annual limit on elective deferrals under a tax-sheltered annuity is $9,500 rather than $7,000. The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

Elective deferrals under a tax-sheltered annuity program consist of those employer contributions made pursuant to a salary reduction agreement, whether evidenced by a written instrument or otherwise (sec. 3121(a)(5)(D)), to the extent those contributions are excludable from the employee's gross income. If, however, an employee has a one-time election to participate in a program that requires a pre-tax contribution (or a post-tax employee contribution in lieu of a pre-tax contribution) as a condition of participation, such contribution will not be considered an elective deferral to the extent that the employee is not permitted subsequently to modify the election in any manner (including modifying the election to make post-tax contributions rather than pre-tax contributions). In addition, the Secretary is authorized to prescribe additional instances in which pre-tax contributions to a plan will not be considered elective despite the existence of limited rights of election by the employee.

If an employee has made more than 1 election, it is presumed that pre-tax contributions subject to the elections are elective deferrals. The presumption can only be rebutted by evidence demonstrating that a subsequent election was made following a bona fide separation from service, and not a temporary absence.

Special catch-up election

The Act provides an exception to the $9,500 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the limit on contributions and benefits (sec. 415)) in the case of employees of an educational organization, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additional salary reduction contribution under the following conditions:

(1) In no year can the additional contributions be more than $3,000 (and, therefore, the $9,500 limit may not be increased above $12,500);

(2) An aggregate, lifetime limit of $15,000 applies to the total amount of catch-up contributions (i.e., contributions that, in any year, exceed the limit on elective deferrals for that year); and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the number of years of service (within the meaning of sec. 403(b))[36] that the individual performed with the employer.

Further, it is intended that the definition of years of service for purposes of the special catchup election will include principles similar to the principles of section 414(a). For this purpose, an employee's years of service will be determined by including all years of service with a predecessor employer (within the meaning of sec. 414(a)). Thus, years of service with a denomination of a church that merges into or combines with another denomination generally are to be aggregated with years of service with the surviving denomination.

Because employers may not have records for prior years with respect to the portion of contributions to tax-sheltered annuities that were elective deferrals, it may be difficult for employers to calculate the lifetime limit for an employee. It is expected that the Secretary will provide administrable methods that employers can use to calculate elective deferrals for prior years.

Effective Dates

The provisions are effective for taxable years beginning after December 31, 1986. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Revenue Effect

This provision and the provisions discussed in 2., 3., and 4., of this Part A are estimated to increase fiscal year budget receipts by $310 million in 1987, $628 million in 1988, $691 million in 1989, $809 million in 1990, and $924 million in 1991.

7. Special rules for simplified employee pensions (sec. 1108 of the Act and sec. 408(k) of the Code)[37]

Prior Law

Under prior and present law, if an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction limit is increased to the lesser of $30,000 or 15 percent of compensation. Under prior law, the increased deduction limit applied only to employer contributions made on behalf of an employee to the SEP on a nonelective basis.

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[36] A technical correction may be needed so that the statute reflects this intent.

[37] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1208; S.Rep. 99-313, pp. 569-572; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 406-408 (Conference Report).

Reasons for Change

Congress recognized that small employers often failed to establish pension plans for employees because of the administrative costs and burdens attributable to such plans. Even the generous tax incentives under prior law had not significantly improved pension coverage for employees of small businesses.

Congress believed that simplified employee pensions provided a low-cost retirement savings option to employers that should be encouraged. Therefore, Congress adopted miscellaneous SEP changes designed to further simplify the administration of SEPs and to add a special elective deferral feature available only to small employers.

Explanation of Provisions

In general

The Act revises the qualification requirements relating to SEPs to permit employees to elect to have SEP contributions made on their behalf or to receive the contributions in cash. In addition, the Act makes miscellaneous changes to the SEP requirements to decrease the administrative requirements applicable to an employer maintaining a SEP.

Salary reduction SEPs

Under the Act, employees who participate in a SEP are permitted to elect to have contributions made to the SEP or to receive the contributions in cash. If an employee elects to have contributions made on the employee's behalf to the SEP, the contribution is not treated as having been distributed or made available to the employee. In addition, the contribution is not treated as an employee contribution merely because the SEP provides the employee with such an election. Therefore, under the Act, an employee is not required to include in income currently the amounts the employee elects to have contributed to the SEP. Elective deferrals under a SEP are to be treated in the same manner as elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $7,000 (indexed) cap on elective deferrals.

Consistent with the rules applicable to elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity under present and prior law, elective deferrals under a SEP are not excludable from the definition of wages for employment tax purposes.

The Act provides that the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, this exception to the constructive receipt principle is available for a taxable year only if the employer maintaining the SEP had 25 or fewer employees at all times during the prior taxable year.

In addition, under the Act, the amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate. The deferral percentage for each highly compensated employee cannot exceed 125 percent of the average deferral percentage for all other eligible employees. Of course, integration under section 401(l) is not permitted in applying this 125-percent test. Also, nonelective SEP contributions may not be combined with the elective SEP deferrals for purposes of this test. Finally, an employer may not make any other SEP contributions conditioned on elective SEP deferrals.

Under the Act, the definition of a highly compensated employee is the uniform definition applied for purposes of the nondiscrimination rules for qualified plans and employee benefit plans.

In calculating the deferral percentages, an employee's compensation is determined in accordance with the new definition of compensation (sec. 414(s)) (see Part B.7., below).

If the 125-percent test is not satisfied, rules similar to the rules applicable to excess contributions to a cash or deferred arrangement is to apply.

The Act does not change the prior-law status of SEPs for purposes of Title I of ERISA.

SEP deduction converted to exclusion from income

Under the Act, the amounts contributed to a SEP by an employer on behalf of an employee and the elective deferrals under a SEP are excludable from gross income, rather than deductible as under prior law.

In addition, the Act (1) modifies the rules relating to maintaining a SEP on a calendar year basis, and (2) prescribes rules for maintaining a SEP on a taxable year basis. In the case of a SEP maintained on a calendar year basis, contributions made in a calendar years are deductible for the taxable year with which or within which the calendar year ends, and the contributions are treated as made on the last day of the calendar year if the contributions are made by the due date (plus extensions) of the employer's tax return.

In the case of a SEP maintained on a taxable year basis, contributions are deductible for the taxable year and contributions are treated as made on the last day of the taxable year if the contributions are made by the due date (plus extensions) of the employer's tax return for the taxable year.

In addition, under the Act, the definition of wages for FICA (sec. 3121(a)(5)) and FUTA (sec. 3306(b)(5)) purposes and for purposes of determining benefits under the Social Security Act[38] is amended to exclude those SEP contributions that are made pursuant to a salary reduction agreement.

Participation requirements

Under the Act, the participation requirements for SEPs are modified to require that an employer make contributions for a year on behalf of each employee who (1) has attained age 21,[39] (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $300 in compensation from the employer for the year. Thus, the Act adds a de minimis exception to the requirement that contributions are to be made on behalf of all employees.

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[38] A technical correction may be needed so that the statute reflects this intent.

[39] Age 25 is reduced to age 21 under the provisions of the Act making technical corrections to the Retirement Equity Act of 1984.

In addition, the Act provides that this 100-percent participation requirement applies separately to elective arrangements and, for purposes of such elective arrangements, an individual who is eligible is deemed to receive an employer contribution. If nonelective SEP contributions are made for any employee, nonelective contributions are to be made for all employees satisfying the participation requirements. Similarly, if any employee is eligible to make elective SEP deferrals, all employees satisfying the participation requirements are to be eligible to make elective SEP deferrals.

Wage-based contribution limitation for SEPs

Under the Act, the $200,000 limit on compensation taken into account under a SEP and the $300 de minimis threshold are indexed at the same time and in the same manner as the dollar limits on benefits under a defined benefit pension plan (sec. 415(d)).

Definition of computation period

Subject to any terms and conditions that the Secretary may prescribe, the Act permits an employer to elect to use its taxable year rather than the calendar year for purposes of determining contributions to a SEP.

Integration rules

The Act eliminates the current rules under which nonelective SEP contributions may be combined with employer OASDI contributions for purposes of the applicable nondiscrimination requirements. In place of these rules, the Act permits nonelective SEP contributions to be tested for nondiscrimination under the new rules for qualified defined contribution plans permitting a limited disparity between the contribution percentages applicable to compensation below and compensation above the integration level.

Effective Date

The provisions apply for years beginning after December 31, 1986, except that the new integration rules are effective for years beginning after December 31, 1988.[40]

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $15 million in 1987, $32 million in 1988, $35 million in 1989, $41 million in 1990, and $47 million in 1991.

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[40] A technical correction may be needed so that the statute reflects this intent with respect to the effective date of the integration rules.

8. Deductible contributions permitted under section 501(c)(18) plans (sec. 1109 of the Act and sec. 501(c)(10) of the Code)[41]

Prior Law

Under prior and present law, a trust or trusts created before June 25, 1959, forming part of a pension plan funded solely by contributions of employees is entitled to tax-exempt status under section 501(a) of the Code (sec. 501(c)(18)) if certain requirements are satisfied.

Rev. Rul. 54-190, 1954-1 C.B. 46, concluded that contributions to a pension plan described above were deductible as union dues by an employee making such contributions. In 1982, the Internal Revenue Service declared Rev. Rul. 54-190 obsolete.[42]

Reasons for Change

Congress was concerned that the historical treatment of contributions under a section 501(c)(18) pension plan had been disrupted by the Internal Revenue Service. While Congress believed that the characterization of such pension contributions as union dues was inappropriate and failed to recognize the true nature of the contribution, Congress found it necessary to provide a mechanism to allow deductions, within limits, for contributions to such plan.

However, Congress believed that employees should not be permitted to contribute to such a pension plan on a deductible basis unless the plan met requirements similar to the rules provided with respect to qualified cash or deferred arrangements, including the limits on annual elective deferrals and the special nondiscrimination rules applicable to such arrangements.

Explanation of Provisions

Under the Act, employees who participate in a section 501(c)(18) pension plan are permitted to elect to make deductible contributions if certain requirements are met. If an employee elects to make a deductible contribution to the plan, the contribution is deductible up to the lesser of $7,000 (coordinated with the limit on elective deferrals) or 25 percent of the compensation of the employee includible in income for the taxable year.

The Act provides that the election to make deductible contributions to a section 501(c)(18) plan is available only if the plan satisfies a special nondiscrimination test similar to the test applicable to a qualified cash or deferred arrangement. If the test is not satisfied, rules similar to the rules applicable to excess contributions under a qualified cash or deferred arrangement are to apply.

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[41] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1209; S.Rep. 99-313, pp. 573-574; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 408-409 (Conference Report).

[42] Rev. Rul. 82-127, 1982-1 C.B. 215.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

B. Nondiscrimination Requirements

1. Minimum coverage requirements (secs. 1112, 1115, and 1120 of the Act and secs. 402, 403, 410, and 414 of the Code) [1]

Prior Law

A plan generally satisfied the prior-law coverage rule if the plan benefited either (1) a significant percentage of the employer's workforce (percentage test), or (2) a classification of employees determined by the Secretary not to discriminate in favor of employees who were officers, shareholders, or highly compensated (classification test).

Percentage test

A plan met the percentage test if it benefited either (1) at least 70 percent of all employees, or (2) at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees were eligible to benefit under the plan (i.e., the plan benefited at least 56 percent of all employees).

Classification test

A plan met the classification test if the Secretary determined that it covered a classification of employees that did not discriminate in favor of employees who were officers, shareholders, or highly compensated (highly compensated employees).

Under Treasury regulations, the determination as to whether a classification discriminated in favor of highly compensated employees was to be made on the basis of the surrounding facts and circumstances of each case, allowing for a reasonable difference between the ratio of highly compensated employees who were benefited by the plan to all such employees and the corresponding ratio calculated for employees who were not highly compensated.

Published rulings (e.g., Rev. Rul. 83-58[2]) applying the classification test included as relevant facts and circumstances the percentage of total employees covered under the plan and the compensation of the covered employees compared to the compensation of the excluded employees. Under the regulations, a showing that a specified percentage of participants in a plan were not highly compensated was not sufficient to establish that the plan did not discriminate in favor of highly compensated employees.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 1113 and 1116; H.Rep. 99-426, pp. 709-16; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1212 and 1215; S.Rep. 99-313, pp. 575-586; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 410-420 (Conference Report).

[2] 1983-2 C.B. 70.

Nondiscriminatory contributions or benefits

Under prior and present law, additional tests are applied to determine whether contributions or benefits under a plan discriminate in favor of highly compensated employees (sec. 401(a)(4)). These requirements are satisfied if either the contributions or the benefits under a qualified plan do not discriminate in favor of highly compensated employees.

Aggregation rules

Aggregation of employers.—Under prior and present law, in applying the qualification rules (including the coverage and nondiscrimination tests), all employees of corporations that are members of a controlled group of corporations, or all employees of trades and businesses (whether or not incorporated) that are under common control, are aggregated and treated as if employed by a single employer (sec. 414(b) and (c)). Similarly, all employees of employers that are members of an affiliated service group are treated as employed by a single employer for certain purposes, including the coverage and nondiscrimination tests (sec. 414(m)).

In addition, for purposes of certain rules, again including the coverage and nondiscrimination tests, an individual ("leased employee") who performs services other than as an employee for a person and who meets certain requirements is treated as an employee of that person (sec. 414(n)). Finally, the Secretary has general regulatory authority to prevent avoidance of certain pension requirements through the use of certain arrangements (sec. 414(o)).

Aggregation of plans and comparability.—Under prior and present law, an employer may designate two or more plans as a single plan for purposes of satisfying the coverage requirements.[3] However, if several plans are designated as a single plan, the plans, considered as a unit, are required to provide contributions or benefits that do not discriminate in favor of highly compensated employees.

In determining whether one or more plans designated as a single plan provide benefits or contributions that do not discriminate in favor of highly compensated employees, it is necessary to determine whether the designated plans provide "comparable" benefits or contributions. Under prior law, Rev. Rul. 81-202[4] provided guidance in determining whether the amounts of employer-derived benefits or contributions provided under several plans were comparable or whether the plans discriminated in favor of highly compensated employees.

Excludable employees

In applying the percentage test under prior law, employees who had not met a minimum service or age requirement under the plan were disregarded. In addition, in applying the percentage test or the classification test, employees not covered by the plan and subject to a collective bargaining agreement between employee representatives and 1 or more employers were disregarded, as were nonresident aliens with no earned income from the employer constituting United States source income. Also, in the case of a trust maintained pursuant to a collective bargaining agreement between airline pilots and 1 or more employers, all employees not covered by the agreement generally were disregarded for purposes of the percentage test and the classification test.

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[3] Treas. Reg. sec. 1.410(b)-1(d)(3)(ii) prohibits this designation in certain cases involving TRASOPs and, prior to 1984, certain plans subject to sec. 401(a)(17). In addition, Treas. Reg. sec. 54.4975-11(e)(1) prohibits this designation in certain cases involving ESOPs.

[4] 1981-2 C.B. 93.

Tax-sheltered annuities

Under prior law, no coverage or nondiscrimination rules prohibited an employer's tax-sheltered annuity program from favoring highly compensated employees.

Reasons for Change

For many years, Congress has provided tax incentives for employers to provide retirement benefits. The objective of these incentives has been the provision of such benefits to nonhighly compensated employees. The means chosen to accomplish this objective has been nondiscrimination rules that restrict the tax benefits to plans that provide benefits for nonhighly compensated employees that are comparable to those provided for highly compensated employees.

Congress was concerned that the prior-law coverage tests for qualified plans, by permitting large disparities in the coverage percentages of highly compensated employees and nonhighly compensated employees, were not sufficient to ensure nondiscriminatory coverage of nonhighly compensated employees. The coverage rules provided by the Act generally are intended to deny tax benefits to plans if the average benefit provided to highly compensated employees exceeds by more than specified limits the average benefit provided to other employees.

Explanation of Provisions

a. Overview

The Act modifies the coverage rules for qualified plans and extends those modified rules to matching and nonelective contributions to tax-sheltered annuities. In addition, the Act imposes special requirements relating to the availability of elective contributions under tax-sheltered annuities.

b. Qualified plan coverage

In general

Under the Act, a plan is not qualified unless the plan satisfies at least one of the following coverage requirements:

(1) the plan benefits at least 70 percent of all nonhighly compensated employees (the "percentage test");

(2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan (the "ratio test"); or

(3) the plan meets the average benefits test.

A plan maintained by an employer that has no nonhighly compensated employees is deemed to satisfy the coverage requirements.[5]

In addition, the Act clarifies the fact that a failure to meet the new coverage requirements due to unforeseen circumstances (such as an unexpected reduction in the workforce) does not affect application of the tests.

Average benefits test

In general.—A plan meets the average benefits test if (1) the plan benefits such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated employees ("classification test"); and (2) the average benefit percentage for nonhighly compensated employees of the employer is at least 70 percent of the average benefit percentage for highly compensated employees of the employer.

Classification test.—For purposes of the average benefits test, the classification test is generally to be based on the prior-law section 410(b)(1)(B) (as modified judicially and administratively in the future). However, it is to be applied using the new definitions of highly compensated employees and excluded employees. See Part B.7. and "Excluded employees," below.

Thus, the test is to be applied on the basis of the facts and circumstances of each case, including the difference between the coverage percentages of the highly compensated employees and the other employees, the percentage of total employees covered, and the difference between the compensation of the covered employees and the compensation of the excluded employees. Nevertheless, Congress expects that the Secretary will consider providing an objective safe harbor rule based on these and other relevant factors to facilitate compliance with the test.

Average benefit percentage.—The term "average benefit percentage" means, with respect to any group of employees, the average of the benefit percentages calculated separately with respect to each employee in such group. The term "benefit percentage" means the employer-provided contributions (including forfeitures) or benefits of an employee under all qualified plans of the employer, expressed as a percentage of such employee's compensation. If benefit percentages are determined on the basis of employer-provided contributions, all employer-provided benefits are to be converted into contributions for testing purposes. Similarly, if benefit percentages are determined on the basis of employer-provided benefits, all employer-provided contributions are to be converted into benefits. In determining the amount of contributions or benefits, the approach of Rev. Rul. 81-202 is to be the sole rule applicable, as modified in the manner described below. Thus, in the case of benefits testing, the benefit percentages are determined based on projected benefits.

Congress intended that the rules of Rev. Rul. 81-202 be modified in several respects, both for purposes of the average benefit percentage test and for purposes of determining whether two or more plans that are treated as a single plan under the percentage test, ratio test, or classification test discriminate in favor of highly compensated employees (sec. 401(a)(4)). First, Rev. Rul. 81-202 is to be modified to reflect the new limits contained in the Act on the extent to which a plan may be integrated. Also, the new limitation on the amount of compensation that may be taken into account (sec. 401(a)(17)) and the new definition of compensation (sec. 414(s)) apply under Rev. Rul. 81-202 as they apply for all nondiscrimination rules.

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[5] A technical correction may be needed so that the statute reflects this intent.

Rev. Rul. 81-202 is also to be modified to take into account other significant plan features. For example, determinations under Rev. Rul. 81-202 are to take into account the rate at which benefits actually accrue and, in appropriate cases, may take into account the existence of different plan options such as loans or lump-sum distributions that are available to highly compensated participants, but not to a proportionate number of nonhighly compensated participants. Moreover, Congress clarified that under Rev. Rul. 81-202 the same actuarial assumptions are to be used in valuing different benefits or contributions. In appropriate circumstances, Rev. Rul. 81-202 may also be modified to take into account reasonable salary projections. The Secretary may also, in circumstances justifying special scrutiny, consider requiring a certificate of comparability from an enrolled actuary.

Finally, Congress did not intend to restrict the authority of the Secretary to modify, as appropriate, aspects of Rev. Rul. 81-202 not discussed above. Also, Congress did not intend that application of the rules of Rev. Rul. 81-202 to the average benefit percentage test be interpreted as requiring that an averaging approach be adopted for purposes of applying these rules to multiple plans being tested as a single plan under section 401(a)(4).

For purposes of determining benefit percentages, all pre-tax contributions or benefits provided under a qualified plan are considered employer-provided and are to be taken into account, including, for example, elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)). In no case may an employer disregard any qualified plan in determining benefit percentages, even if such qualified plan satisfies the percentage test or ratio test standing alone. Contributions or benefits under other types of plans or programs (such as SEPs (sec. 408(k)) or tax-sheltered annuity programs (sec. 403(b))) are not taken into account.

After the benefit percentage of each employee is determined in the manner described above, the average for the 2 groups (highly compensated employees and nonhighly compensated employees) is then determined by averaging the individual benefit percentages of each employee (including employees not covered by any qualified plan) in a manner similar to the computation of the actual deferral percentage of a group of employees under a qualified cash or deferred arrangement.

Period of computing percentage.—The Act provides that each employee's benefit percentage is to be computed, at the election of the employer, on the basis of contributions or benefits for (1) the current plan year, or (2) a period of consecutive plan years (not in excess of 3 years) ending with the current plan year. The period of consecutive plan years chosen by the employer is to be uniformly applied in computing each employee's benefit percentage, and may not be changed without the consent of the Secretary.

Employees benefiting under the plan

For purposes of the new coverage rules, an employee generally will be treated as benefiting under the plan only if the employee is a participant with respect to whom the plan benefit accrues or, in the case of a defined contribution plan, is contributed. However, in the case of a qualified cash or deferred arrangement or the portion of a defined contribution plan to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make or receive (as applicable) contributions under the plan.

However, for purposes of the average benefit percentage component of the average benefits test, it is actual benefits, not eligibility, that is taken into account with respect to all types of plans. As under prior law, this is also true for purposes of establishing comparability between plans.

Aggregation of plans and comparability

As under prior law, for purposes of applying the percentage test or the ratio test, more than 1 plan may be designated as a single plan and tested as a unit if the plans so designated provide benefits that do not discriminate in favor of highly compensated employees. Also, for purposes of satisfying the average benefits test, 2 or more comparable plans may be aggregated for purposes of determining whether the plans together satisfy the classification test.

Under the Act, the method of determining comparability is modified in the manner described above with respect to the average benefits test.

Excluded employees

For purposes of determining whether a plan satisfies the coverage rules, the Act generally provides that the employer is to exclude from consideration certain classes of employees.

Minimum age and service.—If a plan (1) prescribes minimum age or service requirements as a condition of participation, and (2) excludes all employees who do not satisfy such requirements, then the employer is to disregard such employees in applying the percentage test, ratio test, and classification test. For purposes of the average benefit percentage component of the average benefits test, the employer is either to take into account all employees or, alternatively, exclude those employees who have not satisfied the minimum age and service requirements that are the lowest minimum age and service requirements for any plans taken into account in applying the test. The lowest age and service requirements used need not be the age and service requirements under the same plan.

Separate testing.—The Act permits employees who do not meet the statutory age 21 and 1 year of service requirements (sec. 410(a)(1)(A)) ("excludable employees") to be excluded from consideration despite the fact that certain of such excludable employees are covered under a plan, if the coverage rules are satisfied with respect to the excludable employees, treating the excludable employees as the only employees of the employer.

An employer may elect to test all such excludable employees separately. Alternatively, an employer may elect to test one group of excludable employees separately without testing all excludable employees separately if such group is defined in a nondiscriminatory manner solely by reference to the age or service requirements. For example, an employer may elect to test separately all employees excludable solely on the grounds that they do not have 1 year of service, but not include in such testing group employees excluded under the age rule. (Of course, in this case, the rule permitting employees to be disregarded if the separate testing requirement is satisfied only applies to employees excludable on the grounds that they do not have 1 year of service.) Also, the employer may test separately a group of employees who would pass an age or service requirement that is less restrictive than the age 21 or 1 year of service requirement. For example, an employer could test separately all employees excludable solely on the grounds that they are not age 21, but who are at least 18.

Collective bargaining agreement.—For purposes of applying (1) the percentage test, (2) the ratio test, or (3) the average benefits test (including the classification test component) to qualified plan coverage of employees who are not included in a unit of employees covered by a collective bargaining agreement, all employees covered by such an agreement are disregarded. However, in applying the same tests to employees covered by any such agreement, no such exclusion exists, so no employee may be disregarded based on whether or not such employee is covered under a collective bargaining agreement.

For example, assume an employer has 1,100 employees who may not be excluded from consideration for any purpose. The employer also has 500 employees ("union employees") who are included in a unit of employees covered by a collective bargaining agreement and thus are to be excluded for purposes of testing the plan coverage of employees not subject to a collective bargaining agreement, but who may not be excluded from consideration for any other purpose. Assume further that 100 of the 1,100 nonunion employees are highly compensated employees and that none of the union employees is a highly compensated employee.

The employer maintains only 1 plan. That plan covers all 100 of the highly compensated employees, 700 of the 1,000 nonunion nonhighly compensated employees, and 300 of the union employees. In determining whether this plan satisfies the coverage rules, 2 steps are necessary. First, the employer is required to test the coverage of the nonunion employees as if the union employees did not exist. Under this part of the test, the employer covers 100 percent of the nonunion highly compensated employees and 70 percent of the nonunion nonhighly compensated employees. Thus, the plan satisfies the ratio and percentage tests with respect to coverage of nonunion employees. (If, however, only 699 of the nonunion nonhighly compensated employees were covered, the plan would fail to satisfy the coverage rules because union employees may not be taken into account in testing coverage of nonunion employees.)

Under the second part of the test, the employer is required to test the coverage of union employees. For this purpose, the employer may deem such coverage to be pursuant to a separate plan. In this example, a separate plan providing coverage to the union employees would satisfy the ratio test since the only employees covered are nonhighly compensated employees.

Assume, as a second example, that all 1,100 of the nonunion employees are covered by the plan. Assume further that 200 of the 500 union employees are highly compensated employees and that they and 200 other union employees are covered by the plan. Again, under the first part of the test, coverage of the nonunion employees satisfies the ratio and percentage tests if the union employees are disregarded. With respect to the coverage of union employees, if such coverage were considered to be pursuant to a separate plan, such plan would cover 66⅔ percent of the highly compensated employees and approximately 15 percent of the nonhighly compensated employees. If tested as a separate plan, this would not satisfy the ratio or percentage tests. Thus, in this case, the employer would not want to deem the coverage of union employees to be pursuant to a separate plan. When considered together with coverage of the nonunion employees, coverage of the union employees satisfies the ratio and percentage tests since approximately 92 percent of all nonhighly compensated employees are covered (1,200 of 1,300). These results are attributable to the fact that in testing coverage of union employes, nonunion employees are taken into account.

Miscellaneous.—As under prior law, nonresident aliens with no United States source earned income are disregarded for purposes of applying the coverage rules. Also as under prior law, in the case of a collective bargaining agreement covering a unit of airline pilots, employees not covered by the agreement are disregarded.

Definition of employer; line of business or operating unit

As under prior law, all employees of related employers are aggregated and treated as if employed by a single employer (sec. 414(b), (c), (m), and (o)). Also, the employee leasing rules, as modified by the Act (see Part E.8., below), continue to apply (sec. 414(n)).

If, however, an employer, as defined under the above aggregation rules, is treated as operating separate lines of business or operating units for a year, the employer may apply the coverage rules separately to each separate line of business or operating unit for that year. This rule does not apply, however, to any plan that does not satisfy the classification test on an employer-wide basis.

For further discussion of the line-of-business or operating-unit rule, see Part F.1., below.

Compensation

The Act provides a definition of the term "compensation" that, except as otherwise expressly provided (e.g., the definition of compensation for purposes of identifying the highly compensated employees), applies for purposes of applying the coverage and nondiscrimination rules[6] (including the actual deferral percentage limits for qualified cash or deferred arrangements and the contribution percentage limits for employee and employer matching contributions). Under the Act, the definition of compensation generally is the same definition used for purposes of the limit on contributions (sec. 415(c)(3)).[7] However, in addition, an employer may elect to treat salary reduction amounts under a qualified cash or deferred arrangement, tax-sheltered annuity program, SEP, or cafeteria plan, as compensation, provided that such treatment is applied on a consistent basis under rules prescribed by the Secretary. Thus, for example, if an employer elects to treat elective deferrals under one qualified cash or deferred arrangement as compensation, it is required to treat all elective deferrals under all qualified cash or deferred arrangements as compensation. Further, the Secretary is directed to prescribe alternative definitions of compensation for use by employers in applying the coverage and nondiscrimination tests. Such alternative definitions are to include the basic or regular compensation of employees (e.g., disregarding bonuses and overtime). An employer may use an alternative definition prescribed by the Secretary only if it does not discriminate in favor of the employer's highly compensated employees; such determination is to be made in an objective fashion on the basis of the employees' compensation as defined for purposes of the limit on contributions.

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[6] The Act provides that the definition of compensation applies "for purposes of this part." Congress intended such definition to apply only where it is specifically cross-referenced. A technical correction may be needed so that the statute reflects this intent.

Special rules for certain dispositions and acquisitions

The Act contains a special transition rule for certain dispositions or acquisitions of a business. Under the Act, if a person becomes or ceases to be a member of a controlled group (sec. 414(b) and (c)) or affiliated service group (sec. 414(m)), the coverage rules will, with respect to a plan maintained by the person or group, be deemed satisfied during the transition period, provided that (1) the coverage rules were satisfied immediately before the acquisition or disposition, and (2) the coverage under the plan (or under another plan on which the plan relied to satisfy the coverage rules) does not change significantly during the transition period (other than by reason of the acquisition or disposition). The transition period is defined as the period beginning on the date of the acquisition or disposition and ending on the last day of the first plan year beginning after the transaction.

This rule is not intended to compel employers to determine if the coverage rules were satisfied immediately prior to any disposition or acquisition to which the rule could apply. For example, if an insignificant disposition or acquisition occurs during a transition period with respect to a prior disposition or acquisition, an employer might want to apply the special rule throughout the existing transition period, rather than determine if the coverage rules actually are satisfied immediately prior to the subsequent disposition or acquisition. Thus, employers may apply the coverage rules without regard to this special rule.

In addition, this special rule is to be applied under rules prescribed by the Secretary in a manner consistent with the purposes of the coverage rules. For example, this special rule is to grant relief only with respect to that part of the coverage rules affected by the disposition or acquisition. For example, if the employer applies the coverage rules separately to separate lines of business, and the employer disposes of one of such incorporated lines of business, the effect of this rule simply may be to allow the employer to continue to apply the coverage rules separately to the other lines of business during the transition period. This is so because although the disposition of 1 line of business can affect an employer's option to apply the coverage rules separately to other lines of business (e.g., by causing a plan to fail the classification test on an employer-wide basis), such disposition does not affect the application of the coverage rules to the other lines of business if such lines of business can continue to be tested separately. This assumes that the identity of the highly compensated employees is not affected by the disposition of the line of business. See discussion below.

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[7] A technical correction may be needed so that the statute reflects this intent.

Former employees

Under rules prescribed by the Secretary, the coverage rules are to apply separately to former employees. Congress intended that for this purpose, rules similar to those applicable to statutory employee benefit plans are to be applied, taking into account the different nature of qualified plans. (See Part F.1., below.)

Sanction

The Act modifies the sanction applicable to a plan that fails to qualify due solely to a failure to satisfy the new coverage rules. Under the Act, nonhighly compensated employees are not taxable on amounts contributed to or earned by the trust merely because a plan fails to satisfy the coverage requirements. Highly compensated employees, on the other hand, are taxable on the value of their vested accrued benefit attributable to employer contributions and vested income on any contributions to the extent such amounts have not previously been taxed to the employee. Except for these 2 changes, the sanctions applicable under prior law are not modified. Thus, as under prior law, in appropriate circumstances, the Internal Revenue Service may apply lesser sanctions than the maximum authorized sanctions.

c. Tax-sheltered annuities

In general

The Act generally applies the qualified plan coverage and nondiscrimination rules (secs. 410(b) (i.e., without regard to sec. 410(c)) and 401(a)(4), (5), and (26)), as modified and added by the Act, to the nonelective and matching contributions or benefits of tax-sheltered annuity programs (other than those maintained for church employees). Except as otherwise noted below, these rules apply in the same manner to tax-sheltered annuity programs as they do to qualified plans. Thus, the full array of rules relating to nondiscrimination apply (such as, for example, the limit on the amount of compensation that may be taken into account, the special nondiscrimination rule applicable to matching contributions, the employee leasing rules, and the minimum participation rules).

To the extent the program permits elective deferrals, a special coverage and nondiscrimination rule applies to those elective deferrals.

Integration

As with respect to qualified plans, employers maintaining tax-sheltered annuity programs generally may integrate contributions or benefits under the new integration rules for purposes of the average benefits test (sec. 410(b)), for establishing comparability between programs (or between a program and a plan), and for satisfying the benefits test within a plan (sec. 401(a)(4)). However, under rules prescribed by the Secretary, there is no permitted disparity under the new integration rules for employees who are not covered by social security.

Permissive aggregation

If a tax-sheltered annuity program, standing alone, fails to satisfy the percentage test, the ratio test, or the classification test, the employer may elect to treat the tax-sheltered annuity program and a qualified plan or another tax-sheltered annuity program as a single plan solely for purposes of demonstrating that the tax-sheltered annuity program satisfies the coverage requirements. If a tax-sheltered annuity program is aggregated with another tax-sheltered annuity program or with a qualified plan for purposes of satisfying the coverage rules, the aggregated arrangements are required to provide contributions or benefits that do not discriminate in favor of highly compensated employees (secs. 401(a)(4) and 401(m)).

The requirement that such aggregated arrangements provide comparable contributions or benefits generally applies in the same manner to tax-sheltered annuity programs as it does to qualified plans. Thus, the principles of Rev. Rul. 81-202 apply, as modified in the manner described in Part B.1.b., above. However, Congress intended that the Secretary is to prescribe rules applicable to tax-sheltered annuities that reduce the administrative burden of applying Rev. Rul. 81-202. For example, the Secretary might permit, under appropriate circumstances, testing less frequently than annually.

In applying the average benefit percentage component of the average benefits test to a tax-sheltered annuity program, an employer may at its election include all qualified plans in determining the average benefit percentages.

A tax-sheltered annuity program may not be aggregated with a qualified plan for purposes of determining whether the qualified plan satisfies the applicable coverage and nondiscrimination rules, including the average benefits test.

Excluded employees

The categories of employees that are excluded in applying the coverage rules to tax-sheltered annuity programs are the same as those that are excluded in applying the rules to qualified plans, except that, in addition, an employer is to exclude from consideration students who normally work less than 20 hours per week. This additional category of excluded employees is treated in the same manner as the category of employees who do not meet the service requirements for qualified plans. Thus, for example, the 20-hour requirement only applies if the employer excludes all students normally working less than 20 hours per week.

Elective deferrals

The Act provides a special coverage and nondiscrimination rule applicable to tax-sheltered annuity programs that permit elective deferrals. If the employer also provides nonelective or matching contributions or benefits under a program, the special rule applies only to the elective deferrals and the general nondiscrimination rules described above apply to the other contributions or benefits. Thus, for example, in applying the average benefits test to nonelective and matching contributions, elective deferrals are disregarded. Of course, if the employer maintains a tax-sheltered annuity program that permits only elective deferrals (i.e., no nonelective or matching contributions or benefits are provided), only the special rule for elective deferrals applies.

If any employee of the employer sponsoring the tax-sheltered annuity program may make elective deferrals under a tax-sheltered annuity program, the program will be considered discriminatory with respect to elective deferrals unless the opportunity to make elective deferrals of more than $200 is available to all employees on a basis that does not discriminate in favor of highly compensated employees. In applying this special test for elective deferrals, no employees may be excluded from consideration other than (1) nonresident aliens with no United States source earned income; (2) students of the employer who normally work less than 20 hours per week; and (3) employees who are participants in an eligible deferred compensation plan (sec. 457), qualified cash or deferred arrangement (sec. 401(k)), or another tax-sheltered annuity program maintained by the employer. The first 2 exclusions apply in the same manner as discussed above with respect to the general rules for excludable employees. For purposes of the third exclusion, an employee who is eligible for a benefit under one of the plans or programs listed is considered a participant under such plan or program even if such employee does not actually benefit under the plan or program. Other exclusions under the qualified plan rules, such as those based on age, service, or coverage under a collective bargaining agreement, do not apply.

Elective deferrals under a tax-sheltered annuity program consist of those employer contributions made pursuant to a salary reduction agreement, whether evidenced by a written instrument or otherwise (sec. 3121(a)(5)(D)), to the extent those contributions are excludable from the employee's gross income. If, however, an employee has a 1-time election to participate in a program that requires a pre-tax contribution (or a post-tax employee contribution in lieu of a pre-tax contribution) as a condition of participation, such contribution will not be considered an elective deferral to the extent that the employee is not permitted subsequently to modify the election in any manner (including modifying the election to make post-tax contributions rather than pre-tax contributions). In addition, the Secretary is authorized to prescribe additional instances in which pre-tax contributions to a plan will not be considered elective despite the existence of limited rights of election by the employee.

If an employee has made more than 1 election, it is presumed that pre-tax contributions subject to the election are elective deferrals. The presumption can only be rebutted by evidence demonstrating that a subsequent election was made following a bona fide separation from service, and not a temporary absence.

Employers subject to the nondiscrimination rule

The Act provides that for purposes of the coverage and nondiscrimination rules applicable to tax-sheltered annuity programs, the general rules regarding aggregation of employers, employee leasing, and testing on a line of business or operating unit basis are to apply under rules prescribed by the Secretary (sec. 414(b),(c), (m), (n), (o), and (r)). The Secretary may provide for a narrower definition of employer for purposes of the rules applicable to elective deferrals.

In general, all employers eligible to sponsor a tax-sheltered annuity program are subject to the coverage and nondiscrimination rules added by the Act. However, these rules do not apply to tax-sheltered annuity programs maintained for church employees.

For purposes of this exclusion, the term "church" is defined to include only a church described in section 501(c)(3) or a qualified church-controlled organization. These terms generally have the same meaning as they do for purposes of exclusion from the SECA and FICA taxes (secs. 1402 and 3121). Accordingly, for purposes of this provision, the term "church" includes (1) a convention or association of churches, and (2) an elementary or secondary school that is controlled, operated, or principally supported by a church or by a convention or association of churches.

Similarly, the term "qualified church-controlled organization" means any church-controlled tax-exempt organization described in section 501(c)(3) other than an organization that both (1) offers goods, services, or facilities for sale (other than on an incidental basis) to the general public (e.g., to individuals who are not members of the church), other than goods, services, or facilities that are sold at a nominal charge that is substantially less than the cost of providing such goods, services, or facilities, and (2) normally receives more than 25 percent of its support from either (a) governmental sources, or (b) receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses, or from (a) and (b) combined.

In addition, for purposes of the exemption from the coverage and nondiscrimination rules, congregationally organized churches or conventions or associations of churches generally are not to be treated differently than hierarchically organized churches or conventions or associations of churches in determining whether particular organizations are "qualified church-controlled organizations." Therefore, an organization will not fail to be treated as church-controlled if it is controlled by or associated with (within the meaning of section 414(e)(3)(D)) a church or convention or association of churches.

Effective Dates

In general, the new coverage rules apply to plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

The new definition of compensation applies to years beginning after December 31, 1986.

The application of the nondiscrimination rules to tax-sheltered annuity programs is effective for plan years beginning after December 31, 1988. A special effective date applies to programs maintained pursuant to a collective bargaining agreement.[8]

Revenue Effect

The provision is estimated to increase budget receipts by less than $5 million annually in fiscal years 1987-1991.

2. Minimum participation rule (sec. 1112 of the Act and sec. 401(a)(26) of the Code)[9]

Prior Law

Under prior and present law, an employer may designate two or more plans as a single plan for purposes of satisfying the coverage requirements applicable to qualified plans (sec. 410(b)). (See Part B.1., above, for a discussion of the coverage rules applicable to qualified plans.) However, if several plans are designated as a single plan, the plans, considered as a unit, are required to provide contributions or benefits that do not discriminate in favor of highly compensated employees (sec. 401(a)(4)).

In determining whether several different plans designated as a unit provide benefits or contributions that do not discriminate in favor of highly compensated employees, it is necessary to determine whether the different plans provide "comparable" benefits or contributions. Rev. Rul. 81-202[10] provides guidance that is applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminates in favor of highly compensated employees. That ruling provides (1) methods for adjusting all types of benefits to a standard form; (2) methods for converting benefits into contributions, and contributions into benefits; and (3) methods for imputing the value of employer-provided social security benefits.

The ruling generally provides that the amount of employer-derived benefits provided by a plan or plans will be considered nondiscriminatory if either contributions or benefits do not constitute a greater percentage of nondeferred compensation for any highly compensated employee than for any nonhighly compensated employee. The ruling allows either contributions or benefits to be compared regardless of the type of plans involved.

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[8] A technical correction may be needed so that the statute reflects this intent.

[9] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1212; S.Rep. 99-313, pp. 586-588; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 420-424 (Conference Report).

[10] 1981-2 C.B. 93.

Reasons for Change

Congress believed that it was inappropriate to permit an employer to maintain multiple plans, each of which covered a very small number of employees. Although plans that are aggregated are required to satisfy comparability requirements with respect to the amount of contributions or benefits, such an arrangement may still discriminate in favor of the prohibited group. Differences in the rates at which benefits are accrued (e.g., presence or absence of past service credit) and the selective use of actuarial assumptions in valuing plan benefits may cause a plan that satisfies the requirement of comparability with respect to the amount of contributions or benefits to favor the highly paid. Similarly, in the case of plans that are comparable with respect to the amount of contributions or benefits, discrimination in favor of the highly paid may occur because disparate funding levels and benefit options are not taken into account for purposes of such a comparability analysis.

Although such arrangements were vulnerable to challenge as discriminatory under prior law, Congress was concerned that because of the large number of these arrangements, the inherent complexity of comparability analysis, and the difficulties in discovering all differences in funding levels and benefit options, the IRS lacked sufficient resources to monitor compliance with the nondiscrimination standards by small aggregated plans. Accordingly, the Act establishes a new "minimum number of participants" rule that is required to be satisfied by all plans on an individual plan basis.

Explanation of Provision

In general

Under the Act, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer. The requirement may not be satisfied by aggregating comparable plans. Also, the requirement applies on an employer-wide basis and may not be applied on a line of business or operating unit basis. In the case of a cash or deferred arrangement or the portion of a defined contribution plan (including the portion of a defined benefit plan treated as a defined contribution plan (sec. 414(k))) to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make or receive contributions under the plan. Also, except to the extent provided in regulations, a plan will not satisfy the minimum participation rule for a year unless it satisfies the rule on each day of the year.

Definition of plan

The Act provides that, under regulations prescribed by the Secretary, any separate benefit structure, any separate trust, or any separate arrangement with respect to a defined benefit plan may be treated as a separate plan for purposes of applying the minimum participation rule. Thus, for example, a plan that provides 2 different formulas for calculating participants' benefits or contributions may be treated as at least 2 plans. Also, if defined benefit plan assets are payable from more than one source, such as from more than one trust, each source of assets may be considered a separate plan. If any particular persons have any priority (under the terms of the plan or by arrangement outside of the plan) with respect to a source of assets for defined benefits, such as a right to some or all of a possible reversion, such persons may be considered the sole participants with respect to that plan.

In general, it is the intent of Congress to define "plan" in such a way as to carry out the purposes of the minimum participation rule. Thus, if there is a single defined benefit structure and a single source of assets, there may be more than one plan for purposes of this rule if, under all the facts and circumstances (including those outside of the plan), the arrangement has an effect similar to providing a plan or account to a group of employees that would not satisfy the minimum participation rule. For example, a group of employees might agree to provide each one of them with investment authority with regard to a separate pool of assets held with respect to the defined benefit structure. If such employees may be compensated in any manner, inside or outside the plan, by reference to the results of their investments, each part of the pool of assets may be considered a separate plan benefiting the participant controlling the investment thereof.

In addition, the term "plan" is to be defined so as to preclude the use of structures such as defined benefit plan-defined contribution plan combinations (with benefit offsets) to avoid the rule.

Sanction for failing minimum participation rule

If any plan, as specially defined herein, fails to satisfy the minimum participation rule, the entire plan (as otherwise defined) of which the specially defined plan is a part fails to satisfy the qualification standard (sec. 401(a)).

This sanction (disqualification of the entire plan in cases in which the minimum participation rule is violated with respect to a portion of the plan) may have an unduly harsh effect in the case of a multiple employer plan. In such cases, if the minimum participation rule is not satisfied with respect to any employer participating in the plan, the entire plan is disqualified. Congress intended that the Treasury will apply principles similar to those set forth in the preamble to the Treasury regulations under section 413 in which it is stated that the IRS will administer the provisions of section 413 in a manner that will shelter innocent and nonnegligent employers from some of the harsh effects of disqualification. Therefore, the preamble provides that, in appropriate cases, the IRS may retain the qualified status of a plan for innocent employers by requiring corrective and remedial action with respect to the plan, such as allowing the withdrawal of the offending employer, allowing a reasonable period of time to cure a disqualifying defect, or requiring plan amendments to prevent future disqualifying events.

Excludable employees

The Act generally provides that, for purposes of applying the minimum participation rules, the same categories of employees may be disregarded as may be disregarded for purposes of applying the general coverage rules. In the case of a plan covering only employees included in a unit of employees covered by a collective bargaining agreement, all employees not included in such unit may be disregarded for purposes of satisfying the minimum participation rule. This exception does not apply to any collectively bargained plan that covers any professional (e.g., a doctor, lawyer, or investment banker). No inference is intended from this rule that a plan covering a professional may be a collectively bargained plan.

The Act clarifies how the minimum participation rules apply with respect to coverage of employees who could be excluded under the age or service rules from participation in a qualified plan. Generally, the rule is to apply as if the only employees of the employer were the excludable employees who may be tested separately under the coverage tests. However, all employees of the employer are to be taken into account if any highly compensated employee is covered as an excludable employee for more than one year.

In addition, if any excludable employee is covered under a defined benefit pension plan, all employees of the employer are to be taken into account in applying the minimum participation rule to such plan, except if (1) the benefits provided under such coverage are comparable (or less than comparable) to the coverage of nonexcludable employees; and (2) the plan covering such excludable employees would satisfy the minimum participation rule (taking into account all employees of the employer) but for the fact that such plan has a different defined benefit structure from the plan covering the nonexcludable employees. Thus, payments with respect to defined benefits provided to excludable employees are required to come from the same source as payments with respect to defined benefits provided to nonexcludable employees. All employees of the employer are to be taken into account if only the excludable employees are covered by a defined benefit plan.

If excludable employees may be tested separately under the rules described above, such employees may be disregarded in applying the minimum participation rule to other employees.

Special rules for acquisitions and dispositions

The special rule for certain dispositions or acquisitions of businesses under the general coverage rules (see the discussion in 1., above) also applies for purposes of the minimum participation rule.[11]

Exception for certain plans

Under the Act, the minimum participation rule generally does not apply to a multiemployer plan. This exemption does not apply to a multiemployer plan that covers any professional (e.g., a doctor, lawyer, or investment banker). No inference is intended from this rule that a plan covering a professional may be a multiemployer plan.

The Secretary may also exempt from the application of this rule 2 limited situations. The Secretary may, under appropriate conditions, exempt a plan that benefits no employee who is or ever has been a highly compensated employee with respect to service being credited under the plan, provided that such plan is not necessary for another plan or plans to satisfy the applicable coverage rules (sec. 410(b)).

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[11] A technical correction may be needed so that the statute reflects this intent.

The Secretary may, under appropriate conditions, also exempt a plan that may not be terminated on account of the provisions of the Single Employer Pension Plan Amendment Act (SEPPAA) because it is underfunded during the years that the plan may not be terminated.[12] However, such exemption may not apply unless benefit accruals cease and the plan eliminates, under rules prescribed by the Secretary, any different benefit structure or separate arrangement (as described above).

Effective Dates

The provisions are generally effective for plan years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Further, the Act provides that if (1) a plan is in existence on August 16, 1986, (2) the plan would fail to meet the requirements of the minimum participation rule if such rule were in effect on August 16, 1986, and (3) there is no transfer of assets to or liabilities from the plan, or merger or spinoff involving the plan, after August 16, 1986, that has the effect of increasing the amount of assets available for an employer reversion, such plan may be terminated and the 10-percent excise tax on the reversion of assets (see Part D.3., below) will not be imposed on any employer reversion from such plan. Such termination and reversion are permissible even though the terminating plan relies on another plan that is not terminated for qualification. In determining the amount of any such employer reversion, the present value of the accrued benefit of any individual who is a highly compensated employee is to be determined by using an interest rate that is equal to the maximum interest rate that may be used for purposes of calculating a participant's accrued benefit under section 411(a)(11)(B). (See Part E.4., below.) The Secretary is to prescribe rules preventing avoidance of this interest rate rule through distributions prior to or in lieu of a reversion.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

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[12] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H. Con. Res. 395 which passed the House and Senate in the 99th Congress.

3. Vesting standards (sec. 1113 of the Act, sec. 203 of ERISA, and sec. 411 of the Code)[13]

Prior Law

In general

To ensure that employees with substantial periods of service with an employer do not lose plan benefits upon separation from employment, prior law generally required that, under a qualified plan, (1) a participant's benefits be fully vested upon attainment of normal retirement age under the plan; (2) a participant be fully vested at all times in the benefit derived from employee contributions; and (3) employer-provided benefits vest at least as rapidly as under one of three alternative minimum vesting schedules (Code sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions was required to become nonforfeitable (vested) at varying rates upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting was required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting began at 25 percent after completion of 5 years of service and increased gradually to 100 percent after completion of 15 years of service. The third schedule took both age and service into account, but, in any event, required 50-percent vesting after 10 years of service, and an additional 10-percent vesting for each additional year of service until 100-percent vesting was attained after 15 years of service.

Patterns of discrimination

Vesting more rapid than otherwise permitted may be required under a qualified plan under prior and present law to prevent discrimination if (1) there has been a pattern of abuse under the plan tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or (2) there has been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 411(d)(1)).

Top-heavy plans

Under prior and present law, for any plan year for which a qualified plan is top heavy, an employee's right to accrued benefits must become nonforfeitable under one of two alternative schedules. Under the first top-heavy schedule, a participant who has completed at least 3 years of service with the employer maintaining the plan must have a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions.

A plan satisfies the second alternative (6-year graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the end of

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[13] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1213; S.Rep. 99-313, pp. 588-592; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 424-426 (Conference Report).

2 years of service, 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of service, and 100 percent at the end of 6 years of service with the employer.

Class-year plans

Under prior law, special vesting rules applied to "class-year plans." A class-year plan is a profit-sharing, money purchase, or stock bonus plan that provides for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements were satisfied under prior law if the plan provided that a participant's right to amounts derived from employer contributions with respect to any plan year were nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

Changes in vesting schedule

Under prior law, if a plan's vesting schedule was modified by plan amendment, the plan was not qualified unless each participant with no less than 5 years of service was permitted to elect, within a reasonable period after the adoption of the amendment, to have the nonforfeitable percentage of the participant's accrued benefit computed under the plan without regard to the amendment.

Minimum period of service

Under prior law, a plan could require that an employee complete 3 years of service to be eligible to participate in the plan. If the plan required a participant to complete more than 1 year of service as a condition of plan participation, the plan was required to also provide that each participant in the plan had a nonforfeitable right to 100 percent of the participant's accrued benefit under the plan as the benefit was accrued.

Reasons for Change

Congress believed that prior law did not meet the needs of many workers who changed jobs frequently. In particular, women and minorities were disadvantaged by the prior-law rules because they tended to be more mobile, shorter service employees. In addition, lower-paid employees, in general, were more likely to be mobile and thus more likely to terminate employment before vesting in any accrued benefits. Accordingly, Congress believed that more rapid vesting would enhance the retirement income security of low- and middle-income employees.

In addition, Congress concluded that an employee who (directly or indirectly) may have accepted a reduced current compensation package in exchange for qualified plan benefits should not have had receipt of plan benefits made contingent on an overly lengthy deferred vesting schedule. At the same time, Congress believed that some deferral of vesting is appropriate to preclude the vesting of very short-service or transient workers. Accordingly, the Act provides for more rapid vesting than that permissible under present law, but does not require immediate vesting.

Explanation of Provision

In general

The Act provides that a plan is not a qualified plan (except in the case of a multiemployer plan) unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative minimum vesting schedules.

A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

Top-heavy plans

The provisions of the Act relating to vesting do not alter the requirements applicable to plans that become top heavy. Thus, a plan that becomes top heavy is required to satisfy 1 of the 2 alternative vesting schedules applicable to top-heavy plans.

Class-year plans

A plan with class-year vesting will not meet the qualification standards of the Code unless, under the plan's vesting schedule, a participant's total accrued benefit derived from employer contributions becomes nonforfeitable at least as rapidly as under 1 of the 2 alternative vesting schedules specified in the Act.

Changes in vesting schedule

Under the Act, if a plan's vesting schedule is modified by a plan amendment, the plan will not be qualified unless each participant with at least 3 years of service is permitted to elect, within a reasonable period after the adoption of the amendment, to have the nonforfeitable percentage of the participant's accrued benefit computed without regard to the plan amendment.

Multiemployer plans

As an exception to the general vesting requirements, the Act provides that, in the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100-percent vested no later than upon the participant's completion of 10 years of service. This exception applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Minimum period of service

Under the Act, a plan may require, as a condition of participation, that an employee complete a period of service with the employer of no more than 2 years. A plan that requires that an employee complete more than 1 year of service as a condition of participation is also required to provide that each participant in the plan has a nonforfeitable right to 100 percent of the participant's accrued benefit under the plan as the benefit is accrued.

PBGC guarantees

Benefits that become vested as a result of the modification of the vesting requirements are to be immediately guaranteed by the PBGC (without regard to the phase-in rule).

Effective Dates

The provisions of the Act generally apply to plan years beginning after December 31, 1988, with respect to participants who have at least 1 hour of service after the effective date.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

4. Application of nondiscrimination rules to integrated plans (sec. 1111 of the Act and secs. 401(a)(5) and (l) of the Code)[14]

Prior Law

In general

Prior and present law provide nondiscrimination standards for qualified pension, profit-sharing, and stock bonus plans. These standards prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated. Under prior law, coverage tests were applied to determine whether the classification of employees who participated in a plan was discriminatory.

Additional tests are applied under prior and present law to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees. These nondiscrimination requirements are satisfied if either the contributions or the benefits under a qualified plan do not discriminate in favor of highly compensated employees.

Generally, in applying the nondiscrimination test to benefits under a plan, the benefits that are provided by the plan for highly compensated participants (as a percentage of their compensation) are compared to the benefits that are provided for other participants. A similar test may be applied to employer contributions under a plan. A plan fails the nondiscrimination standard if both benefits and contributions discriminate in favor of officers, shareholders, or highly compensated employees.

Under prior law, in determining whether defined benefit pension plan benefits, as a percentage of compensation, discriminated in favor of employees who were officers, shareholders, or highly compensated, the portion of each employee's social security benefits that was considered to be paid for by the employer could be taken into account. For this purpose, social security benefits meant old age, survivors, and disability insurance (OASDI) benefits provided under the Social Security Act.

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[14] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1211; S.Rep. 99-313, pp. 592-599; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 427-440 (Conference Report).

Section 401(l) and Revenue Rulings 71-446 (1971-2 C.B. 187) and 83-110 (1983-2 C.B. 70) provided guidance for calculating the maximum amount of social security benefits that could be taken into account under an employer's qualified plan. In addition, under prior and present law, section 401(a)(15) prevents increases in social security benefits after an employee's separation from service with an employer from reducing plan benefits. Also, section 411(b)(1)(G) provides that an employee's accrued benefit (other than a social security supplement) under a defined benefit plan may not be reduced on account of any increase in the employee's age or service. Finally, section 411(d)(6) provides that, with limited exceptions, the accrued benefit of a participant may not be decreased by plan amendment. Under prior law, a plan that met the nondiscrimination standards of the Code only if social security benefits were taken into account was referred to as an integrated plan. Either benefits or contributions under a plan could be integrated.

Integration of defined benefit pension plans

Two basic approaches to integration of defined benefit pension plans had been developed: (1) the "offset" approach, and (2) the "excess" approach.

Offset plans

A defined benefit pension plan that integrated under the offset approach was referred to as an offset plan. An offset plan initially provided each employee with an annual pension benefit which (as a percentage of compensation) did not discriminate in favor of highly compensated employees. For each employee, this initial benefit was then reduced, or offset, by the employer-provided portion of that employee's social security benefit to arrive at the actual pension benefit under the plan.

In 1971, the Internal Revenue Service determined that the value of employer-provided social security benefits was equal to 83⅓ percent of the annualized primary insurance amount (PIA) to which an employee was entitled under the Social Security Act. This calculation formed the basis of the prior-law rules for integrating offset plans. Consequently, an offset plan without integrated ancillary benefits could integrate its normal retirement benefits with social security by providing each employee retiring under the plan an annual benefit of, for example, 50 percent of pay offset by 83⅓ percent of the employee's PIA. If an offset plan provided employees with integrated ancillary benefits (e.g., normal retirement benefits not in the form of an annuity, preretirement death benefits, and early retirement benefits), the prior-law rules required that the 83⅓ percent factor be reduced.

Excess plans

A pension plan that integrated under the excess approach was referred to as an excess plan. The basic theory underlying the excess approach was that the social security system provided benefits based on only a certain portion of an employee's earnings. An excess plan was designed to provide benefits (or added benefits) based on the portion of an employee's earnings "in excess" of the integration level, on the earnings on which social security benefits were provided. An excess plan properly integrated if the benefits provided by the plan with respect to compensation in excess of the integration level were not greater, as a percentage of pay, than the benefits provided by social security on compensation up to the integration level.

The Internal Revenue Service determined that the employer-provided portion of benefits under social security averaged 37½ percent of the average annual maximum wages on which social security benefits were based (covered compensation). This calculation formed the basis of the prior-law rules for integrating excess plans. Consequently, for an employee retiring at age 65 with at least 15 years of service in 1986, an excess plan would integrate properly if it provided benefits at a rate no greater than 37½ percent of final average compensation in excess of approximately $15,000 (covered compensation for such an employee), although it provided no benefits with respect to the first $15,000 of final pay.

If an excess plan provided benefits on compensation up to covered compensation, then it could provide benefits at a higher rate on pay above the level of covered compensation. However, the rate at which benefits were provided above covered compensation could not exceed the rate at which benefits were provided on compensation up to covered compensation by more than 37½ percentage points. For example, an integrated excess plan could provide benefits at the rate of 12½ percent for final average compensation up to covered compensation plus 50 percent (i.e., 37½ percent plus 12½ percent) of final pay in excess of covered compensation.

As is the case with an offset plan, if an excess plan had integrated ancillary benefits, the 37½ percent factor was required to be reduced. In addition, the 37½ percent factor was required to be reduced for an excess plan that used an integration wage level higher than covered compensation (or the otherwise applicable maximum integration wage level) or determined a participant's final average compensation on the basis of a period shorter than 5 consecutive years.

A defined benefit plan formula could be either a flat benefit formula, as illustrated above, or a unit benefit formula under which the benefit was based on the number of an employee's years of service with the employer. Examples of fully integrated unit benefit formulas (assuming no required adjustments for ancillary benefits or alternative integration wage levels) were (1) annual benefit at age 65 equal to 1.4 percent of career average compensation in excess of the integration wage level (the taxable wage base) for each year of service with the employer, and (2) annual benefit at age 65 equal to 1 percent of final average compensation in excess of covered compensation times years of service with the employer. Of course, these 1.4 percent and 1 percent factors were required to be reduced if the excess plan had integrated ancillary benefits or used a higher integration wage level.

Under prior law, the integration rules allowed an employer to implicitly take credit for the OASDI contributions of former employers of an employee. Thus, for example, an employee who retired at age 65 with 15 years of service under a flat benefit excess plan could receive a benefit under an integrated plan of 37½ percent of final average compensation in excess of covered compensation, even though the employee worked with the employer only for the last 15 years. The prior-law integration rules were even more generous to employers under an offset plan because the maximum offset of 83⅓ percent could be applied to an employee retiring at age 65 with as little as 1 year of service. OASDI benefits were earned, however, over the entire working career of the employee.

Integration of defined contribution plans

Defined contribution plans do not provide specified benefit formulas. Defined contribution plans provide for contributions to be accumulated in a separate account for each employee. Accordingly, such plans were integrated under prior law by taking into account the employer-paid portion of social security taxes. Specifically, a defined contribution plan was integrated by reducing contributions to the plan with respect to the portion of an employee's pay subject to the social security OASDI tax (i.e., the taxable wage base or $42,000 for 1986).

Prior law provided that an employer could integrate a defined contribution plan by reducing contributions on behalf of an employee by no more than an amount equal to the employee's taxable wage base multiplied by the actual OASDI tax rate. Thus, a profit-sharing plan could provide contributions of 5.7 percent (the OASDI tax rate) of 1986 pay in excess of $42,000 (the 1986 taxable wage base) and no contributions for 1986 with respect to the first $42,000 of pay. Similarly, if a plan provided for 1986 contributions of 10 percent of pay in excess of $42,000, it integrated properly only if it provided for 1986 contributions of at least 4.3 percent with respect to the first $42,000 of pay. For a profit-sharing or stock bonus plan to be properly integrated, the plan must have provided benefits only upon retirement, death, or other separation from service. Adjustments to the 5.7 percent factor were required only if the plan used an integration wage level higher than the current taxable wage base.

Top-heavy plans

Under prior and present law, a qualified plan that is top heavy must provide a minimum nonintegrated benefit or contribution derived from employer contributions for each employee who is a participant in the plan and who is not a key employee (sec. 416). This rule is designed to reflect the higher proportion of tax advantages allocated to the benefit of key employees in a top-heavy plan. Generally, a plan is top heavy if more than 60 percent of the benefits it provides are for key employees (sec. 416).

A defined benefit pension plan satisfies this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant who is not a key employee, when expressed as an annual retirement benefit, is not less than 2 percent of the employee's average annual compensation from the employer (during a specified period), multiplied by the number of the employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation. This required minimum benefit may not be eliminated or reduced on account of the employee's social security benefits (i.e., the minimum benefit is a "nonintegrated" benefit).

For a plan year for which a defined contribution plan is a top-heavy plan, the employer generally must contribute on behalf of each plan participant who is not a key employee an amount not less than 3 percent of the participant's compensation. The minimum contribution must be made for each year in which the plan is top heavy. However, if the employer's contribution rate for each participant who is a key employee for the plan year is less than 3 percent, the required minimum contribution rate for each non-key employee generally is limited to the highest contribution rate for any key employee. The required minimum contribution must be a nonintegrated contribution.

Reasons for Change

Social security benefits do not adequately replace the preretirement earnings of low- and middle-income workers. Because of this fact, and because of the financial inability of many low- and middle-income workers to set aside sufficient savings for retirement, Congress provided tax incentives to encourage employers to provide such workers with additional retirement benefits under qualified plans. The prior-law rules on social security integration, which permitted an employer to eliminate any qualified plan benefits for lower-paid employees, undermined the original Congressional policy for providing the tax incentives for qualified plans.

In addition, Congress believed that the prior-law integration rules were a substantial source of unnecessary complexity in the qualified plan area.

Accordingly, the Act contains provisions that (1) revise and simplify the rules governing the integration of a qualified plan and (2) ensure that all employees covered by the plan receive some minimum benefits.

Explanation of Provision

In general

The Act provides that a plan is not to be considered discriminatory merely because the contributions and benefits of (or on behalf of) employees under the plan favor highly compensated employees if the plan meets the new requirements of the Act relating to the permitted disparity in contributions or benefits.

The additional limits added by the Act on the permitted disparity (1) are a simplified form of the prior-law integration rules, modified to eliminate the need for offset plans to determine an employee's actual lifetime social security benefit, (2) provide for parity between offset plans and excess plans, (3) provide uniform rules for both final average excess plans and career average excess plans, and (4) eliminate the adjustments for integrated ancillary benefits (except for early retirement benefits). In addition, these rules prevent plans from totally denying any type of benefit to a participant under a plan on account of integration.

Congress recognized that some plans that satisfy the prior-law integration rules may not satisfy the additional limits added by the

Act. However, Congress determined that, in attempting to limit the disparity permitted under the new rules to approximate the levels permitted under prior law, the goals of simplifying the integration rules, providing consistent rules for different types of plans, and updating the rules to reflect the current social security system justify the simplified approach adopted under the Act.

In addition, the Act precludes an employer from taking into account benefits attributable to OASDI contributions of former employers of an employee.

The uniform definition of compensation added by the Act (Code sec. 414(s)) applies for purposes of the rules relating to the permitted disparity.

Permitted disparity in defined contribution plans

Under the Act, a defined contribution plan meets the disparity limits for integrated plans only if the excess contribution percentage (i.e., the contribution by the employer with respect to compensation over the integration level, expressed as a percentage of compensation) does not exceed the base contribution percentage (i.e., the contribution by the employer with respect to compensation up to the integration level, expressed as a percentage of such compensation) by more than the lesser of (1) the base contribution percentage, or (2) the greater of 5.7 percentage points or the percentage equal to the portion of the rate of tax in effect under section 3111(a) attributable to old-age insurance as of the beginning of the plan year.[15]

Congress understood that, for 1986, the rate of tax attributable to old-age insurance is less than 5 percent. Congress expected that the Social Security Administration will advise the Secretary when such rate becomes greater than 5.7 percent and, thereafter, will determine the amount of such rate and advise the Secretary for timely publication.

Under the Act, a plan is required to specify the applicable integration level for a year. The maximum integration level permitted for a year, however, is the OASDI contribution and benefit base under social security (taxable wage base) in effect at the beginning of the year. The Secretary may develop such rules as are necessary to prevent an employer from selecting a lower integration level that discriminates in favor of highly compensated employees. Also, contributions subject to the nondiscrimination rules of sections 401(k) (including contributions to plans described in sec. 501(c)(18)), 401(m) (including contributions under tax-sheltered annuities pursuant to sec. 403(b)), or 408(k)(6) may not rely on the integration rules to satisfy such nondiscrimination rules. Finally, the Act does not modify any other requirements currently applicable to integrated defined contribution plans, including, for example, the requirement that an integrated profit-sharing or stock bonus plan provide benefits only upon retirement, death, or other separation from service.

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[15] A technical correction may be needed so that the statute reflects this intent.

Permitted disparity in defined benefit pension plans

In general

The Act provides both ratio limits and percentage point limits on the maximum disparity permitted under a defined benefit excess plan and on the maximum offset permitted under a defined benefit offset plan. The percentage point limits generally are a simplified form of the prior-law integration rules.

Excess plans

In general.—The Act provides that the excess benefit percentage (i.e., benefits provided by the employer with respect to compensation in excess of the applicable integration level, expressed as a percentage of compensation) under a defined benefit excess plan may not exceed the base benefit percentage (i.e., benefits provided by the employer with respect to compensation not in excess of such integration level, expressed as a percentage of such compensation) by more than the maximum excess allowance.

Maximum excess allowance.—In the case of an excess plan, the maximum excess allowance with respect to benefits attributable to any year of service taken into account under the plan is the lesser of (1) the base benefit percentage, or (2) ¾ of a percentage point. The maximum excess allowance for such a plan with respect to total benefits is the lesser of (1) the base benefit percentage, or (2) ¾ of a percentage point times the participant's years of service (not in excess of 35) taken into account under the plan.

These limits apply to excess plans that base benefits on final average compensation as well as excess plans that base benefits on career average compensation. Under the Act, an integrated plan may not base plan benefits on less than any period of at least 3 consecutive years of service (or a participant's full period of service, if less).[16]

A year is treated as taken into account under a plan for purposes of applying the maximum excess allowance if benefits are treated as accruing on behalf of the participant for such year. Thus, for example, an excess plan that provides for the accrual of benefits over a participant's years of participation is to be treated as taking only years of participation into account.

This maximum excess allowance applies to both a flat-benefit final pay plan and a unit-benefit final pay plan. For example, assume a flat-benefit plan with a benefit formula providing a retirement benefit for a participant retiring at age 65 with at least 15 years of participation equal to 20 percent of the participant's final average compensation not in excess of the applicable integration level. Assume further that the plan provides for the accrual of the retirement benefit under the fractional rule of section 411(b). In order to satisfy the new integration rules with respect to a participant retiring at age 65 with 20 years of participation, the plan may not provide a benefit in excess of 35 percent of compensation over the integration level. If this participant had 35 years of participation at age 65, the plan would be precluded from providing a benefit with respect to final average compensation over the integration level in excess of 40 percent of such compensation. If an employee with 10 years of participation in this plan separated from service at age 50, such employee's accrued benefit would be 8 percent of his final average compensation up to the applicable integration level plus up to 15.5 percent of his final average compensation over the integration level.

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[16] A technical correction may be needed so that the statute reflects this intent.

Reductions of the ¾ percent factor.—The Secretary is directed to prescribe regulations requiring the reduction of the ¾ percent factor in the maximum excess allowance for plans (both final average and career average plans) using integration levels in excess of covered compensation. Congress directs the Secretary to provide for such reductions on the basis of brackets of integration levels in excess of covered compensation. Such reductions and brackets should correspond to the comparable reductions and brackets for offset plans. The Secretary is not authorized, however, to provide for an increase in the ¾ factor for plans using integration levels lower than covered compensation.

The term "covered compensation" means, with respect to an employee, the average of the taxable wage bases in effect for each year during the 35-year period ending with the year the employee attains the social security retirement age (as defined in sec. 415),[17] assuming no increase in such wage base for years after the current year and before the employee actually attains the social security retirement age.

Congress intended that the reductions for higher integration levels will reflect the decreasing percentages of compensation replaced by the employer-provided PIA under social security as compensation increases above covered compensation. The Secretary is directed to consult with the Social Security Administration in developing the prescribed reductions.

Optional forms of benefits and other features.—The Act provides that any optional form of benefit, preretirement benefit, actuarial factor, and other factor or feature under the plan provided with respect to compensation above the integration level also be provided with respect to compensation below the integration level. Thus, for example, if a lump sum distribution option, calculated using particular actuarial assumptions, is available with respect to benefits relating to compensation above the integration level, the same lump sum option is to be available on an equivalent basis with respect to benefits based on compensation up to the integration level.

Multiple integration levels.—The Secretary is directed to provide rules under which an excess plan may use 2 or more integration levels. The permitted disparity with respect to each such integration level should be based on the percentages of compensation up to each such level replaced by the employer-provided portion of PIA under social security.

Offset plans

The Act provides that, in the case of a defined benefit offset plan, a participant's accrued benefit may not be reduced by reason of the offset by more than the maximum offset allowance for such participant. The maximum offset allowance with respect to a participant for any year of service taken into account under the plan is the lesser of (1) 50 percent of the benefit that would have accrued without regard to the offset reduction, or (2) ¾ percent of the participant's final average compensation times the participant's years of service with the employer (not in excess of 35) taken into account under the plan. For purposes of this allowance, a participant's final average compensation is to be calculated by disregarding compensation in any year over the taxable wage base for such year.

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[17] A technical correction may be needed so that the statute reflects this intent.

The Secretary is directed to reduce the ¾ factor under the maximum offset allowance for participants with final average compensation in excess of covered compensation. Such reductions are to be based on the decreasing percentages of compensation replaced by the employer-provided PIA under social security as compensation increases above covered compensation. The Secretary is directed to consult with the Social Security Administration in developing such prescribed reductions. In addition, the reductions applicable to the ¾ factor for offset plans should correspond to the reductions applicable to the ¾ factor for excess plans using integration levels in excess of covered compensation. Finally, Congress directed the Secretary to publish annually a table setting forth the appropriate offset factors for brackets of final average compensation in excess of covered compensation.

The term "offset plan" means any defined benefit plan under which the employer-provided benefit for each participant is reduced by an amount specified in the plan. Such term does not include a qualified plan merely because the benefits under such plan are reduced by benefits under another qualified plan. The reduction under an offset plan with respect to a participant may not exceed the maximum offset allowance for such participant. In addition, an offset plan is required to base benefits on average annual compensation for at least the lesser of (1) a consecutive 3-year period or (2) the total number of the participant's years of service.[18] An offset plan may reduce participants' benefits by less than the maximum offset allowance so long as the offset amount or formula is specified in the plan, does not discriminate in favor of highly compensated employees, and is not otherwise inconsistent with the purposes of the integration rules.

Reductions for early retirement benefits

Under the Act, the Secretary is also directed to reduce the ¾ percent factor in the maximum excess allowance and maximum offset allowance for plans providing for unreduced benefits (other than for disability, as defined under the Social Security Act) commencing before the social security retirement age (as defined in sec. 415). The ¾ percent factor is to be reduced by 1/15 for each of the first 5 years that the benefit commencement date precedes the social security retirement age (currently age 65), and by an additional 1/30 for each of the next 5 years that the benefit commencement date precedes the social security retirement age. If the benefit commencement date is earlier than 10 years before the social security retirement age, the factor is to be actuarially reduced for each such additional year. Also, as under prior law, the determination of whether early retirement benefits require an adjustment is based on a comparison of the benefit actually provided under the plan at the early retirement age with the benefit that would be provided under a plan at such age that has the maximum disparity permitted under the integration rules (calculated by applying the $\frac{1}{15}$, $\frac{1}{30}$ adjustment).

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[18] A technical correction may be needed so that the statute reflects this intent.

Multiple integrated plans

The Act provides that the Secretary is to develop rules to prevent excessive use of the disparity permitted under this provision with respect to any employee through the integration of more than one qualified plan. Such rules are to limit to 100 percent the sum of the percentages, calculated separately for each plan with overlapping coverage, of the maximum benefit disparity actually used in each plan.

Benefits limited by reference to final pay

The Act permits a defined benefit plan to limit the employer-provided accrued retirement benefit under the plan for any participant to the excess of the participant's final pay with the employer over the employer-provided PIA actually provided for such participant under social security and attributable to service by the participant with the employer. This limit is applied to the participant's accrued retirement benefit (disregarding ancillary benefits) under the defined benefit plan. Similarly, the limit is applied by taking into account only the worker's benefit (PIA) under social security, disregarding ancillary benefits (spousal, survivor, children's, and disability benefits). The Act clarifies that, for purposes of determining the portion of the employer-provided PIA under social security for a participant that is attributable to service with the employer, such PIA is treated as accruing ratably over 35 years. However, Congress does not intend that the limit also be pro rated. Finally, this limit may not be applied either to reduce minimum benefits under the top-heavy rules or to reduce accrued benefits within the meaning of section 411(d)(6).

Effective Date

The provision is effective with respect to benefits attributable to plan years beginning after December 31, 1988. This effective date should not result in double integration with respect to any benefit provided to an employee. Thus, under rules prescribed by the Secretary, coordination of the benefits provided under the rules of prior law and the integration rules in the Act is necessary.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

It is anticipated that Treasury will provide that plan amendments to conform to Rev. Rul. 86-74 (1986-1 C.B. 205) will not be required until such time as the plan is otherwise amended to comply with the Tax Reform Act of 1986 as long as the plan complies in operation with the requirements of that ruling.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

5. Benefits treated as accruing ratably for purposes of determining whether plan is top heavy (sec. 1118 of the Act and sec. 416 of the Code)[19]

Prior Law

In general

For years beginning after December 31, 1983, prior and present law provide additional qualification requirements for plans that primarily benefit an employer's key employees (top-heavy plans) (sec. 416). These additional requirements (1) limit the amount of a participant's compensation that may be taken into account; (2) require more rapid vesting; (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees; and (4) reduce the aggregate limit on contributions and benefits.

Top-heavy plan calculation

A defined benefit pension plan generally was top heavy for a year if, as of the determination date for such year, the present value of the cumulative accrued benefits for participants who are key employees exceeds 60 percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a year if, as of the determination date for such year, the sum of the account balances of participants who are key employees exceeds 60 percent of the sum of the account balances of all employees under the plan (sec. 416(g)).

Accrued benefits

In general, a defined benefit pension plan will not be considered a qualified plan unless participants accrue benefits at a rate that meets one of three alternative schedules (sec. 411(b)). The purpose of these schedules generally is to limit the extent to which an employer may defer (i.e., "backload") benefit accruals.

Under 1 of the 3 alternatives, known as the "fractional rule," each plan participant's accrued benefit at the end of any year must be at least equal to a fractional portion of the retirement benefit to which the participant would be entitled under the plan's benefit formula if the participant continued to earn annually until normal retirement age the same rate of compensation. The fractional portion is determined by dividing the participant's actual years of participation by the total number of years of participation that would have been completed if the participant had continued in service until normal retirement age.

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[19] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1115; H.Rep. 99-426, pp. 720-721; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1218; S.Rep. 99-313, pp. 599-601; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 440-441 (Conference Report).

Under prior law, in determining whether a plan was top heavy, cumulative accrued benefits were calculated using the benefit accrual method selected by the plan. If the plan is determined to be top heavy, the plan generally is required to provide that each participant's minimum benefit is, on a cumulative basis, at least equal to two percent of compensation for each year of service during which the plan is top heavy, not to exceed 20 percent (sec. 416(c)). Under the top-heavy rules, benefits accrued under the plan's benefit formula must be at least equal to the required minimum benefit.

Reasons for Change

Congress was concerned that some employers were trying to avoid application of the top-heavy plan rules by artificially accelerating benefit accruals for non-key employees. If the acceleration was sufficient to ensure that the plan did not provide more than 60 percent of the benefits for key employees, the top-heavy rules (including the top-heavy minimum benefit and vesting rules) did not apply. As a result, the non-key employees often forfeited the benefits. Congress believed that it was appropriate to measure accrued benefits on a uniform basis to protect the benefits of rank-and-file employees.

Explanation of Provision

Under the Act, a uniform accrual rule is used in testing whether a qualified plan is top heavy (or super top heavy) (sec. 416(g)(4)(f)). Thus, solely for determining whether the present value of cumulative accrued benefits for key employees exceeds 60 percent of the present value of cumulative accrued benefits for all employees (90 percent for purposes of the super top-heavy plan rules), cumulative accrued benefits are to be determined by treating the benefits of the participants in each plan as accruing no more rapidly than the slowest permitted rate under the fractional accrual rule.

This rule applies only for purposes of determining whether the plan is top heavy or super top heavy. The rule does not require that the plan actually use the fractional rule for purposes of accruing benefits under the plan.

The Act also provides an exception to the general rule under which, if benefits under all plans of the employer accrue at the same rate, then that accrual rate is to be used in determining whether the plans are top heavy or super top heavy.

Effective Date

The provision applies for plan years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

6. Modification of rules for benefit forfeitures (sec. 1119 of the Act and sec. 401(a)(8) of the Code)[20]

Prior Law

Under prior and present law, when a participant in a qualified plan separates from service, and receives a distribution of the vested plan interest or incurs a five-year break in service, nonvested benefits may be forfeited. In a defined benefit pension plan, forfeitures may not be used to increase promised benefits because benefits must be definitely determinable; instead, forfeitures must be used to reduce future employer contributions or to offset plan administrative expenses.

Under prior law, the treatment of forfeitures in a defined contribution plan depended on whether or not the plan was a money purchase pension plan. In a defined contribution plan that is not a money purchase plan (e.g., a profit-sharing or stock bonus plan), forfeitures may be reallocated to the remaining participants under a formula that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. These reallocated forfeitures increase the benefits of the remaining participants. Alternatively, forfeitures can be used to reduce future employer contributions or to offset administrative expenses.

A money purchase pension plan, like a defined benefit plan, is subject to the requirement that benefits be definitely determinable. Accordingly, a money purchase plan must contain a definite contribution formula. Prior law provided that forfeitures under a money purchase plan could not be used to increase benefits, but were required to be applied to reduce future employer contributions or administrative costs (sec. 401(a)(8)).

Reasons for Change

Congress believed it was appropriate to provide uniform rules for the treatment of forfeitures under all types of defined contribution plans.

Explanation of Provision

The Act creates uniform rules for forfeitures under any defined contribution plan. The Act permits, but does not require, forfeitures to be reallocated to other participants. Thus, forfeitures arising in any defined contribution plan (including a money purchase pension plan) can be either (1) reallocated to the accounts of other participants in a nondiscriminatory fashion, or (2) used to reduce future employer contributions or administrative costs.

Effective Date

The provision is effective for plan years beginning after December 31, 1985.

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[20] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1116; H.Rep. 99-426, pp. 722-723; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1219; S.Rep. 99-313, pp. 601-602; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 442 (Conference Report).

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

7. Definition of highly compensated employees (sec. 1114 of the Act and sec. 414(q) of the Code)[21]

Prior Law

Under prior law, an employee who was an officer, shareholder, or highly compensated was considered a highly compensated individual in whose favor discrimination was prohibited. Prior law did not further define the term "highly compensated" and, under judicial and administrative precedent, the level of compensation that made an employee highly compensated depended on the facts and circumstances of each case.

Reasons for Change

Congress believed that the prior-law definition of the group in whose favor discrimination was prohibited was imprecise and difficult to administer. The Act provides a uniform, more administrable definition of highly compensated employees.

Explanation of Provision

In general

Under the Act, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) received more than $75,000 in annual compensation from the employer; (3) received more than $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as generally defined in sec. 416(i)). The $50,000 and $75,000 thresholds are to be adjusted at the same time and in the same manner as the adjustments to the dollar limit on benefits under a defined benefit plan (sec. 415(d)).[22] The identity of the highly compensated employees is to be determined on an employer-wide basis, not on the basis of, for example, a line of business or operating unit.

Officers

Under the Act, an officer will not be treated as a highly compensated employee, unless such officer receives compensation greater than 150 percent of the defined contribution plan dollar limit in effect for the year. For purposes of this rule, no more than 50 employees (or if lesser, the greater of 3 employees or 10 percent of the employees) are to be treated as officers. If, for any year, no officer has compensation in excess of 150 percent of the defined contribution plan dollar limit, then the highest paid officer of the employer for such year is treated as a highly compensated employee. As under the rules applicable for determining top-heavy status (sec. 416), a partnership is considered to have officers.

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[21] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 1111 and 1151; H.Rep. 99-426, pp. 689-690 and 771-772; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1214; S.Rep. 99-313, pp. 575-86; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 442-448 (Conference Report).

[22] A technical correction may be needed so that the statute reflects this intent.

Top-paid group

The top-paid group of employees includes all employees who are in the top 20 percent of the employer's workforce on the basis of compensation paid during the year. For purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group), the following employees may be excluded: (1) employees who have not completed 6 months of service; (2) employees who normally work less than 17-1/2 hours per week; (3) employees who normally work not more than 6 months during any year; (4) except to the extent provided in regulations, employees who are included in a unit of employees covered by a collective bargaining agreement; (5) employees who have not attained age 21; and (6) employees who are nonresident aliens and who receive no U.S. source earned income. An example of an instance in which it is appropriate to consider employees covered by a collective bargaining agreement is the case in which the plan being tested is maintained pursuant to a collective bargaining agreement.

For purposes of this special rule, an employer may elect to apply numbers (1), (2), (3), and (5) above by substituting any shorter period of service or lower age than is specified in (1), (2), (3), or (5), as long as the employer applies the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business or operating unit rules described in Part F.1., below.

For example, assume an employer's total workforce is 100 employees, 20 of whom have not completed 6 months of service. Assume that none of the 100 employees is within any of the other excluded categories under this rule. Under the above rule, the 20 employees who have not completed 6 months of service may be disregarded in determining the size of the top-paid group. If the 20 employees are disregarded, the top-paid group is 20 percent of 80 employees (the number of employees who are not disregarded), or 16. Thus, the 16 employees who receive the highest compensation (including any employees who have not completed 6 months of service but who are among the 16 highest paid employees of the employer) are in the top-paid group. Each of these 16 employees who receives more than $50,000 in the year is treated as a highly compensated employee. Other employees (and any of the 16 employees receiving less than $50,000) may also be a highly compensated employee under one of the other tests (i.e., officer, 5-percent owner, or compensation over $75,000).

The Act also clarifies that the determination of the top-paid group is made solely with respect to individuals who perform services as an employee at any time during the year. Thus, individuals who separated from service in a prior year are not taken into account in determining the top 20 percent of employees by compensation.

Special rule for determining top-paid group for current year

Under the Act, an employee will not be treated as in the top-paid group, as an officer, or as receiving more than $50,000 or $75,000 solely because of the employee's status during the current year, unless such employee also is among the 100 employees who have received the highest compensation during such year. Under this rule, an individual who was a highly compensated employee for the preceding year (without regard to the 1-year lookback or to the application of this special rule) remains highly compensated for the current year.

Thus, the 100-employee rule is intended as a rule of convenience to employers with respect to new employees hired during the current year, with respect to increases in compensation, and with respect to certain other similar factors. If any employee is not a 5-percent owner or within the top-100 employees by compensation for the current year (and was not a highly compensated employee in the preceding year (without regard to this special rule)), then that employee is not treated as highly compensated for the year, but will be treated as highly compensated for the following year if the employee otherwise falls within the definition of highly compensated employee. However, under the Act, an employer may elect not to apply the 100-employee rule for the current year.

For example, assume that a calendar year employer has 12,000 total employees in 1990 and 1991, and for each year 4,000 employees may be disregarded in determining the number of employees that is to be treated as the number in the top-paid group. Thus, 1,600 (20 percent of 8,000) employees are in the top-paid group. This employer's highly compensated employees for 1991 will include the following:

(1) any employee who owned at any time during 1990 or 1991 more than 5 percent of the employer;

(2) any employee who, in 1990, (a) received more than $75,000 in annual compensation, (b) was an officer (for top-heavy purposes), or (c) received more than $50,000 in annual compensation and was among the 1,600 most highly compensated employees; and

(3) any employee who, in 1991, (a) was an officer (for top-heavy purposes) or received more than $50,000 in annual compensation, and (b) was among the 100 most highly compensated employees.

Thus, an employee who is not a highly compensated employee in 1990 (without regard to this special 100-employee rule) will not be treated as highly compensated for 1991, unless such employee either (1) acquires ownership of more than 5 percent of the employer in 1991 or (2) both becomes 1 of the 100 most highly compensated employees in 1991 and either is an officer or receives more than $50,000 in 1991. Of course, in this example, the minimum 1-officer rule also applies.

Treatment of family members

The Act provides a special rule for the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

For example, if the spouse of the most highly compensated employee of an employer is also an employee and participates in the employer's qualified cash or deferred arrangement, then (1) the elective deferrals made by the spouse and the compensation received by the spouse are aggregated with the elective deferrals made by, and the compensation received by, the most highly compensated employee for purposes of applying the special nondiscrimination test to the elective deferrals of the most highly compensated employee, and (2) the spouse is not treated as a separate employee. Such aggregation applies in the same manner without regard to whether the spouse is also a 5-percent owner or 1 of the top 10 highly compensated employees by compensation.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

The Act also clarifies that, even if a family member is excluded for purposes of determining the number of employees in the top-paid group, such family member is subject to the aggregation rule.

Nonresident aliens

With respect to the determination of the highly compensated employees of an employer, nonresident aliens who receive no U.S. source earned income from the employer are disregarded for all purposes.[23]

Former employees

Under the Act, a former employee is treated as highly compensated if the employee was highly compensated when (1) such employee separated from service or (2) at any time after the employee attained age 55. In addition, Congress intends that the Secretary is to prescribe rules treating an employee who performs only de minimis services as separated from service for purposes of determining whether such employee is a highly compensated employee.

Scope of highly compensated employee definition

Under the Act, the new definition of highly compensated employees applies for purposes of sections 79, 89, 106, 117(d), 120, 127, 129, 132, 274, 401(a)(4), 401(a)(5), 401(k)(3), 401(l), 401(m), 406(b), 407(b), 408(k), 410(b), 411(d), 414(m), 415(c), 423(b), 424(c), 501(c)(17), 501(c)(18), 505, and 4975 of the Code, and 29 U.S.C. sec. 1108.

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[23] A technical correction may be needed so that the statute reflects this intent.

Compensation

For purposes of identifying an employer's highly compensated employees, "compensation" is defined as compensation within the meaning of section 415(c)(3), increased by elective contributions under a cafeteria plan (sec. 125), qualified cash or deferred arrangement (sec. 401(k)), SEP (sec. 408(k)), and tax-sheltered annuity (sec. 403(b)).

Effective Date

The new definition of "highly compensated employee" is generally effective for years beginning after December 31, 1986, except to the extent that the substantive rule to which the definition relates is effective at a later time.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

C. Treatment of Distributions

1. Uniform minimum distribution rules (sec. 1121 of the Act and secs. 401(a)(9) and 4974 of the Code)[1]

Prior Law

Qualified plans

Under present and prior law, a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of each participant will be distributed no later than the participant's required beginning date (sec. 401(a)(9)). Alternatively, the requirements of present and prior law may be satisfied if the participant's entire interest is distributed in substantially nonincreasing annual payments, beginning no later than the participant's required beginning date, over (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the participant, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the participant and a designated beneficiary.

Under prior law, a participant's required beginning date generally was April 1 of the calendar year following the calendar year in which (1) the participant attained age 70½ or (2) the participant retired, whichever was later. If a participant was a 5-percent owner with respect to the plan year ending in the calendar year in which the participant attained age 70½, then the required beginning date under prior law was generally April 1 of the calendar year following the calendar year in which the participant attained age 70½ even if the participant had not retired.

In addition, under present and prior law, the distribution of benefits under a qualified plan is required to satisfy an incidental benefits rule.[2] Under the incidental benefits rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. However, a distribution pattern is not prohibited by the incidental benefits rule to the extent that it is required by the rules relating to qualified joint and survivor annuities.

Present and prior law provides a minimum distribution requirement with respect to benefits payable from a qualified plan with respect to a participant who has died. The minimum distribution requirements vary depending upon whether benefit payments commenced before or after the participant's death.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1121; H.Rep. 99-426, pp. 724-727; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1221; S.Rep. 99-313, pp. 603-607; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 449-452 (Conference Report).

[2] See, e.g., Rev. Rul. 72-241, 1972-1 C.B. 108.

Tax-sheltered annuities

With respect to tax-sheltered annuities and custodial accounts (Code sec. 403(b)), present and prior law provides minimum distribution rules similar to the rules for qualified plans.[3]

IRAs

Present and prior law provides before- and after-death minimum distribution rules for individual retirement arrangements (IRAs) generally corresponding to the rules applicable to qualified plans. Distributions from an IRA, however, are required to commence no later than April 1 of the calendar year following the calendar year in which the owner of the IRA attains age 70½ without regard to whether the owner has separated from service with an employer.

Rollover restrictions

Under prior law (as amended by the technical corrections provisions of the Tax Reform Act of 1986), a 5-percent owner was not permitted to make a rollover contribution to a qualified plan (secs. 401(a) and 403(a)). This rule applied to prevent avoidance of the 10-percent additional income tax on early withdrawals through tax-free rollovers to other qualified plans.

Reasons for Change

Congress was aware that the current absence of uniformity in the minimum required distribution rules applicable to tax-favored plans created significant disparities in opportunities for tax deferral among individuals covered by different types of plans. Uniform rules eliminate such disparities and reduce the complexity of the existing rules.

In particular, for most employees, prior law used separation from service with an employer after age 70½ as the event triggering the required commencement of benefit payments from a qualified plan. However, in the case of a 5-percent owner of an employer or an IRA owner, the attainment of age 70½ without regard to separation from service triggered the required commencement of benefits. Thus, the prior-law rules allowed longer deferrals of tax on accumulations under a qualified plan for participants who were not 5-percent owners.

Further, the time of separation from service was sometimes difficult to determine, as in the case of employees who ceased their regular duties, but continued to work under consulting agreements in order to postpone commencement of retirement benefit payments. Congress believed that a uniform benefit commencement date for all tax-favored retirement arrangements eliminated the disparities among various types of retirement vehicles, and eased administrative burdens in the private and public sectors by eliminating the need for a subjective test to determine when withdrawals are required to begin.

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[3] The technical corrections provisions of the Act make it clear that both the before- and after-death distribution rules applicable to qualified plans also apply to all tax-sheltered annuities and custodial accounts, effective with respect to benefits accrued after December 31, 1986.

Uniform minimum distribution rules which establish the permissible periods over which benefits from any tax-favored retirement arrangement may be distributed ensure that plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income stream at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan.

Congress believed that uniform sanctions should also apply to violations of the minimum distribution rules. The sanction of disqualification of a plan, however, was too onerous for a plan's failure in operation to satisfy technical distribution requirements with respect to any one participant. Disqualification might result in adverse tax consequences to all plan participants or all highly compensated plan participants, even though the plan administrator was responsible for the failure to make a required distribution, and the failure may have occurred with respect to only a single participant. Plan disqualification procedures also imposed a significant administrative burden on the IRS. Although Congress believed that a plan should, by its terms, prohibit the violation of the minimum distribution rules, Congress also believed an operational error should not cause plan disqualification.

Explanation of Provision

Overview

The Act (1) establishes a uniform commencement date for benefits under all qualified plans (secs. 401(a) and 403(a)), individual retirement arrangements (IRAs), tax-sheltered annuities and custodial accounts (sec. 403(b)), and eligible deferred compensation plans of State and local governments and tax-exempt employers (sec. 457 plans); and (2) establishes a new excise tax sanction for failure to satisfy the minimum distribution rules that applies in lieu of plan disqualification.[4]

Uniform benefit commencement date

Under the Act, distributions under all qualified plans, IRAs, tax-sheltered custodial accounts and annuities, and eligible deferred compensation plans of State and local governments and tax-exempt employers are required to commence no later than April 1 of the calendar year following the calendar year in which the participant or owner attains age 70½, without regard to the actual date of separation from service.

Excise tax on failure to make a minimum required distribution

Under the Act, the sanction for failure to make a minimum required distribution to a participant (or other payee) under a qualified retirement plan or an eligible deferred compensation plan (sec. 457) is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the rules of section 401(a)(9), including the incidental benefits rule (the "minimum required distribution"), over the amount that actually was distributed. The tax is imposed on the individual required to take the distribution. However, as under prior law, a plan will not satisfy the applicable qualification requirements unless it expressly provides that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.

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[4] The Act further modifies the minimum distribution requirements for eligible deferred compensation plans of State and local governments and tax-exempt employers (sec. 457 plans). For a discussion of these modifications, see Part A.4., above.

A qualified retirement plan is defined under the Act to include (1) a qualified plan (sec. 401(a)), (2) a qualified annuity plan (sec. 403(a)), (3) a tax-sheltered annuity or custodial account (sec. 403(b)), or (4) an individual retirement arrangement (IRA) (sec. 408).

Under the Act, the Secretary is authorized to waive the tax for a given taxable year if the taxpayer to whom the tax would otherwise apply establishes that any shortfall between the minimum required distribution for that year and the amount actually distributed during the year is due to reasonable error, and that reasonable steps are being taken to remedy the shortfall.

The minimum required distribution in any given taxable year is to be determined under regulations to be issued by the Secretary. Congress intended that if a participant selects a permissible distribution option, the minimum required distribution in any given year is to be the amount required to be distributed in that year under the payout option selected.

With respect to a defined benefit plan, if the participant selects an impermissible payout option and designates a beneficiary, the minimum required distribution in any year is the amount that would have been distributable to the participant in that year had the participant selected a joint and survivor annuity payable over the joint lives of the participant and the beneficiary designated by the participant, taking into account their actual ages on the required beginning date. The survivor benefit is assumed to be the maximum percentage of the annuity payable during the participant's lifetime that will not violate the incidental benefits rule, but not a percentage in excess of 100 percent of the annuity payable to the participant.

If the participant selects an impermissible payout option and does not designate a beneficiary, the minimum required distribution in any year is the amount that would have been distributable to the participant in that year had the participant selected an annuity payable over the life of the participant, taking into account the participant's actual age on the required beginning date.

With respect to any plan other than a defined benefit plan, the minimum required distribution is determined as under prior law.

If an impermissible option is elected, Congress intended that the excise tax apply even if the distribution is described in the plan and the plan receives a favorable determination later.

Of course, the Secretary may provide an alternative method for calculating the amount of the shortfall consistent with the principles set forth above.

Rollover restrictions

The Act repeals the rules prohibiting rollovers by 5-percent owners to qualified plans.[5]

Effective Date

The provisions generally apply to years beginning after December 31, 1988. For purposes of the required beginning date for commencement of benefits, employees who are not 5-percent owners and who have attained age 70½ by January 1, 1988, may defer the commencement of benefit payments under an employer-maintained plan until the employee separates from service with the employer maintaining the plan in which the employee participates. The Act clarifies that this exception applies only if the individual is not a 5-percent owner in the plan year ending with or within the calendar year in which the individual attains age 66½ or any succeeding plan year.

The provisions of the Act relating to required distributions do not apply to accrued benefits under a tax-sheltered annuity that are grandfathered under the technical corrections provisions of the Act. In other words, benefits accrued under a tax-sheltered annuity before January 1, 1987, are not subject to the required distribution rules under the Act.

In addition, an employee is not subject to the 50-percent excise tax for a failure to satisfy the minimum distribution requirements merely because distributions are made to the employee in accordance with a designation made before January 1, 1984, by the employee in accordance with section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

A special effective date applies to collectively bargained plans with respect to individuals who are subject to the collective bargaining agreement.

The repeal of the rollover restrictions applicable to 5-percent owners is effective for rollovers made in years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually for 1987-1991.

2. Uniform additional income tax for early distributions (secs. 1123 and 1124 of the Act and secs. 72 and 403 of the Code)[6]

Prior Law

Withdrawal restrictions

Under present and prior law, benefits generally may be distributed to a participant in a qualified pension plan only on account of plan termination or the employee's separation from service, disability, death, or attainment of normal retirement age. Withdrawals under qualified profit-sharing or stock bonus plans are subject to fewer restrictions than those under qualified pension plans. Qualified profit-sharing or stock bonus plans generally may permit the withdrawal of employer contributions after the expiration of a stated period of time (e.g., 2 years or longer) or after the occurrence of a stated event (e.g., hardship).

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[5] The technical corrections provisions of the Act modify the rules prohibiting rollovers to apply to 5-percent owners rather than key employees.

[6] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1123; H.Rep. 99-426, pp. 727-731; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1223; S.Rep. 99-313, pp. 611-617; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 452-458 (Conference Report).

Special restrictions apply to the withdrawal of elective deferrals under a qualified cash or deferred arrangement. Under present and prior law, a qualified cash or deferred arrangement, by its terms, may not permit a participant to withdraw elective deferrals before the participant dies, becomes disabled, separates from service, or (except in the case of a pre-ERISA money purchase pension plan) attains age 59½ or encounters hardship. Under proposed Treasury regulations, an employee is treated as having incurred a hardship only to the extent that the employee has an immediate and heavy bona fide financial need and does not have other resources reasonably available to satisfy the need.

Under prior law, earnings on elective deferrals were subject to the same withdrawal restrictions as elective deferrals.

Under prior law, withdrawals under a tax-sheltered annuity program invested in a custodial account of a regulated investment company (i.e., a mutual fund) may not be made prior to the time the account owner attains age 59½, dies, becomes disabled, separates from service, or encounters financial hardship. In contrast, amounts invested in tax-sheltered annuities were not subject to any withdrawal restrictions under prior law.

Additional income tax on early withdrawals

Under prior law, a 10-percent additional income tax generally was imposed on withdrawals from an IRA before the owner of the IRA attained age 59½, dies, or becomes disabled. Under prior law, the tax also applied to any withdrawals from qualified plans by or on behalf of 5-percent owners who have not yet attained age 59½, died, or become disabled.

Reasons for Change

Prior law imposed withdrawal sanctions with respect to certain tax-favored retirement arrangements and required withdrawal restrictions to be provided under others. The absence of withdrawal restrictions in the case of some tax-favored arrangements allowed participants in those arrangements to treat them as general savings accounts with favorable tax features rather than as retirement savings arrangements. Moreover, taxpayers who did not have access to such arrangements, in effect, subsidized the general purpose savings of those whose employers maintained plans with liberal withdrawal provisions.

Although Congress recognized the importance of encouraging taxpayers to save for retirement, Congress also believed that tax incentives for retirement savings were inappropriate unless the savings generally were not diverted to nonretirement uses. One way to prevent such diversion was to impose an additional income tax on early withdrawals from tax-favored retirement arrangements in order to discourage withdrawals and to recapture a measure of the tax benefits that had been provided. Accordingly, Congress believed it appropriate to apply an early withdrawal tax to all tax-favored retirement arrangements. For the same reasons, Congress believed it was appropriate to extend the withdrawal restrictions applicable to tax-sheltered custodial accounts to tax-sheltered annuities generally, and to limit the extent to which participants may make hardship withdrawals from a qualified cash or deferred arrangement or a tax-sheltered annuity or account.

Finally, Congress recognized that the prior-law prohibition on distributions from qualified cash or deferred arrangements upon plan termination imposed significant administrative burdens on the trustees of such plans who were required to administer the related trust until all participants had attained age 59½ or separated from service.

Explanation of Provision

In general

The Act (1) modifies the withdrawal restrictions applicable to qualified cash or deferred arrangements, tax-sheltered annuities, and tax-sheltered custodial accounts, and (2) imposes a 10-percent additional income tax on certain early withdrawals from qualified retirement plans.

A qualified retirement plan is defined under the Act to include (1) a qualified plan (sec. 401(a)), (2) a qualified annuity plan (sec. 403(a)), (3) a tax-sheltered annuity or custodial account (sec. 403(b)), or (4) an individual retirement arrangement (IRA) (sec. 408).

Withdrawal restrictions

Qualified cash or deferred arrangements.—Under the Act, a qualified cash or deferred arrangement may make distributions on account of the plan's termination, provided that a successor plan is not established, as well as on account of the employee's death, disability, separation from service, or (except in the case of a pre-ERISA money purchase pension plan) attainment of age 59½. The Act provides that a distribution on account of the termination of a qualified cash or deferred arrangement is to consist of the balance to the credit of the participant under the plan determined under the lump-sum distribution rules (but without regard to the requirements of clauses (i)–(iv) of sec. 402(e)(4)(A) and without regard to secs. 402(e)(4)(B) and (H)).[7]

Distributions on account of hardship are permitted only to the extent of an employee's elective deferrals (but not income on those deferrals under the cash or deferred arrangement). For this purpose, matching contributions and nonelective contributions made by the employer are not considered to be elective deferrals. Thus, if such contributions (or earnings thereon) are taken into account for purposes of the special nondiscrimination rules applicable to qualified cash or deferred arrangements, such contributions (and such earnings) may not be distributed on account of hardship. Prior-law standards governing what constitutes a "hardship" continue to apply.

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[7] A technical correction may be needed so that the statute reflects this intent.

The Act also provides that a distribution from a qualified cash or deferred arrangement may be made (1) upon the disposition by a corporation of the corporation's interest in a subsidiary (within the meaning of sec. 409(d)(3)), with respect to an employee who continues employment with the subsidiary, or (2) upon the disposition by a corporation of substantially all of the assets (within the meaning of sec. 409(d)(2)) used by such corporation in a trade or business of such corporation with respect to an employee who continues employment with the corporation acquiring such assets. As with respect to distributions on plan termination, distributions on the disposition of a subsidiary or of assets are only permitted if they consist of the balance to the credit of an employee under the plan determined under the lump-sum distribution rules (but without regard to the requirements of clauses (i)–(v) of sec. 402(e)(4)(A) and without regard to secs. 402(e)(4)(B) and (H)).[8]

Tax-sheltered annuities.—In addition, the Act provides that the withdrawal restrictions currently applicable to tax-sheltered custodial accounts generally are extended to elective deferrals and earnings on elective deferrals under other tax-sheltered annuities.[9] Early distributions from elective deferrals and earnings on elective deferrals under a tax-sheltered annuity are prohibited unless the withdrawal is made on account of death, disability, separation from service, or attainment of age 59½. Withdrawals on account of hardship from a tax-sheltered annuity or custodial account are permitted only to the extent of the contributions made pursuant to a salary reduction agreement (but not earnings on those contributions) (sec. 3121(a)(5)(D)). The prior-law standards defining "hardship" for purposes of a qualified cash or deferred arrangement will apply in determining what constitutes a hardship under a tax-sheltered annuity.

Tax-credit ESOPs.—Under the Act, distributions from a tax-credit ESOP are permitted upon the plan's termination (provided no successor plan is established) regardless of whether the 84-month rule has been satisfied. The Act provides that the sale of securities held by a tax-credit ESOP, and the transfer of those proceeds to another qualified plan, is permitted upon the termination of the ESOP. See the description in Part G, below.

Additional income tax on early distributions

Overview.—The Act generally extends the additional income tax on early distributions from an IRA to early distributions received by any participant from any qualified retirement plan, subject to certain exceptions.

Under the Act, the additional income tax on early withdrawals applies to certain distributions from any "qualified retirement plan" as defined under the Act. Thus, the tax applies to amounts distributed from plans qualified under section 401(a) or 403(a) of the Code, tax-sheltered annuities and custodial accounts, and IRAs, but does not apply to amounts distributed from eligible deferred compensation plans of tax-exempt employers or State or local governments (sec. 457 plans). Under the Act, the rate of the tax is 10 percent for all early distributions includible in gross income, regardless of the character of the contribution (such as income on after-tax employee contributions) to which the distribution relates.

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[8] A technical correction may be needed so that the statute reflects this intent.

[9] For a discussion of what constitutes an elective deferral under a tax-sheltered annuity, see Part A.6., above.

A plan is not required to withhold the amount of the additional income tax on an early withdrawal.

Under the Act, the additional income tax on early distributions does not apply to the following distributions: (1) a distribution that is part of a scheduled series of substantially equal periodic payments for the life or life expectancy of the participant (or the joint lives or life expectancies of the participant and the participant's beneficiary); (2) a distribution to an employee who has attained age 55 and subsequently separated from service;[10] (3) a distribution made to an employee to the extent such distribution does not exceed the expenses deductible under section 213 for the year (determined without regard to whether the taxpayer itemizes deductions); and (4) distributions after the death of the employee. The Act also includes an exception for certain distributions made from an employee stock ownership plan, but restricts the exception to distributions made prior to January 1, 1990.

In addition, the modifications to the early withdrawal tax under the Act do not apply to the following distributions: (1) lump-sum distributions made prior to March 16, 1987, if the distribution is made on account of separation from service before 1987[11] and the employee treats the distribution for Federal tax purposes as paid in 1986; (2) payments made to or on behalf of an alternate payee pursuant to a qualified domestic relations order (sec. 414(p)); (3) certain distributions of excess contributions, excess deferrals, or excess aggregate contributions (see Part A.2. and 3., above); and (4) dividend distributions for which the employer is allowed a deduction under section 404(k). However, the early withdrawal tax applies without regard to whether a distribution is an involuntary cashout under sections 411(a)(11) and 417(e) (i.e., without regard to whether the present value of the employee's accrued benefit does not exceed $3,500).

Under the Act, the exceptions to the additional income tax on early withdrawals are available to 5-percent owners to the same extent they are available to other employees. In the case of distributions from IRAs (including simplified employee pensions (SEPs)), the age 55, medical expense, and ESOP exceptions do not apply. The exception for distributions pursuant to a qualified domestic relations order applies to an IRA only to the extent the IRA is subject to the rules relating to qualified domestic relations orders. The exception for substantially equal payments applies to distributions from plans qualified under section 401(a) or 403(a) and tax-sheltered annuities and custodial accounts only if the distribution is made after separation from service.

This additional income tax on early withdrawals (sec. 72(t)) applies in the case of distributions of existing qualified voluntary employee contributions (QVECs). It is not intended, however, that QVECs also be subject to the early withdrawal tax under section 72(o).[12] Further, because QVECs are part of a qualified plan, the exceptions available for qualified plans are also available for distributions attributable to QVECs.

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[10] A technical correction may be needed so that the statute reflects this intent.

[11] A technical correction may be needed so that the statute reflects this intent.

Early retirement exception.—The exception for payments under a plan after separation from service following attainment of age 55 continues to apply if the employee returns to work for the same employer (or for a different employer) as long as the employee did, in fact, separate from service before the distribution. In all cases, the exception applies only if the participant has attained age 55 on or before separation from service. Thus, for example, the exception does not apply to a participant who separates from service at age 52 and begins receiving benefits at or after age 55. Of course, one of the other exceptions to the tax may still apply.

Substantially equal payment exception.—The fact that a form of payment contains a term certain does not render the substantially equal payment exception inapplicable if the form otherwise qualifies for the exception (such as a life annuity with a 10-year certain provision). However, a form of payment that consists solely of a term certain (such as a 10-year installment payment option) does not qualify for the exception.

Congress intended that, in the case of a defined contribution plan or an IRA, the exception to the early withdrawal tax is to be available if the plan or IRA purchases a commercial annuity to fund the participant's benefit under which payments are to be made in substantially equal payments over the life of the participant or the joint lives of the participant and the participant's beneficiary or, alternatively, if the plan or IRA distributes the participant's account in substantially equal payments over the life expectancy of the participant or the joint life expectancies of the participant and the participant's beneficiary. A series of payments will not fail to be substantially equal solely because the payments vary on account of (1) certain cost-of-living adjustments; (2) a benefit increase provided to retired employees; (3) an adjustment due to the death of the employee's beneficiary; or (4) the cessation of a social security supplement. These exceptions apply without regard to whether the adjustments or supplements are subsidized by the employer. Congress intended that the Secretary may prescribe regulations setting forth other factors (consistent with the factors prescribed under sec. 401(a)(9)) that will not cause payments to fail to be considered substantially equal.

The Act provides that if distributions to an individual are not subject to the tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed if the individual changes the distribution method prior to age 59½ to a method that does not qualify for the exception (except if the change is by reason of death or disability). The additional income tax will be imposed in the first taxable year in which the modification is made and will be equal to the tax (as determined under regulations) that would have been imposed had the exception not applied. For example, if, at age 50, a participant begins receiving payments under a distribution method which provides for substantially equal payments over the individual's life expectancy and, at age 58, the individual elects to receive the remaining benefits in a single payment, the additional tax imposed will be based on the single payment and on the amounts previously distributed.

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[12] A technical correction may be needed so that the statute reflects this intent.

In addition, this "recapture" tax will apply if an individual does not receive payments under a method that qualifies for the exception for at least 5 years, even if the method of distribution is modified after the individual attains age 59½. Thus, for example, if an individual begins receiving payments in substantially equal installments at age 56, and alters the distribution method to a form that does not qualify for the exception prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59½ as if the exception had not applied. The additional tax will not be imposed on amounts distributed on or after attainment of age 59½. This 5-year minimum payout rule is waived upon the death or disability of the employee.

ESOP exception.—Under the ESOP exception, certain distributions from an ESOP are exempt from the additional income tax on early withdrawals to the extent that the distribution is attributable to assets that have been invested, at all times, in employer securities (as defined in sec. 409(l)) that satisfy the applicable requirements of sections 409 and 401(a)(28) for the 5-plan year period immediately preceding the plan year in which the distribution occurs. Tacking of investment periods is permitted.[13]

For example, amounts transferred to an ESOP would qualify for the exception 3 years after transfer provided the amounts transferred met the investment criteria for 2 years prior to such transfer. In addition, amounts transferred to an ESOP following a reversion from a defined benefit pension plan would qualify for this exception if the 5-year investment requirement is met. It is intended that a first-in, first-out rule be used for purposes of determining the length of time a plan has held securities distributed to a participant.

The exception from the additional income tax on early withdrawals for certain distributions from an ESOP applies to a tax-credit ESOP (sec. 409) as well as an ESOP described in section 4975.[14]

Effective Dates

The provision permitting distributions from a qualified cash or deferred arrangement and from a tax-credit ESOP upon plan termination applies to distributions after December 31, 1984.[15] The provision permitting distributions from a qualified cash or deferred arrangement in connection with the disposition of a subsidiary or of assets is effective for distributions after December 31, 1984. The provision restricting hardship distributions from a qualified cash or deferred arrangement to elective deferrals is effective for years beginning after December 31, 1988. The provisions restricting distributions from a tax-sheltered annuity or custodial account are effective for taxable years beginning after December 31, 1988.

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[13] A technical correction may be needed so that the statute reflects this intent.

[14] A technical correction may be needed so that the statute reflects this intent.

[15] A technical correction with respect to the ESOP rule may be needed so that the statute reflects this intent.

The provisions relating to the additional income tax on early withdrawals apply to all distributions made in taxable years beginning after December 31, 1986. However, the Act contains an exception from the tax for employees who, as of March 1, 1986, had separated from service and commenced receiving benefits from an employer-maintained plan pursuant to a written election designating a specific schedule for the entire accrued benefit of the employee. In addition, if the employee failed to make a written election, the requirement that benefits be paid pursuant to a written election designating a specific schedule for the distribution of the entire accrued benefit of the employee will be deemed satisfied if the plan from which the benefits are paid provides for only 1 form of distribution, or if (1) the plan provides that, in the absence of an election to the contrary, an employee will be paid benefits according to the automatic form of payment specified in the plan, and (2) the employee is, in fact, receiving benefits in that form.

Under a special transition rule, if an employee separates from service before 1987[16] and a lump-sum distribution is received with respect to the employee after December 31, 1986, and before March 16, 1987, on account of the separation from service, the individual, trust, or estate [17] receiving the distribution may treat the distribution as if it was received in 1986. For purposes of this transition rule, whether the amount distributed is a lump-sum distribution is determined without regard to the 5-plan years of participation and election requirements applicable to lump-sum distributions.[18] In addition, for purposes of this special transition rule, a separation from service can occur on account of death and, therefore, payments to a beneficiary may be eligible for the transition rule.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $97 million in 1987, $209 million in 1988, $241 million in 1989, $288 million in 1990, and $353 million in 1991.

3. Taxation of distributions (sec. 1122 of the Act and secs. 72, 402, and 403 of the Code)[19]

Prior Law

In general

Under present and prior law, a distribution of benefits from a tax-favored retirement arrangement generally is includible in gross income unless the amount distributed represents the employee's investment in the contract (i.e., basis). In the case of a distribution from a qualified plan or an IRA, such a distribution is includible in income in the year in which it is paid or distributed.

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[16] A technical correction may be needed so that the statute reflects this intent.

[17] A technical correction may be needed so that the statute reflects this intent.

[18] A technical correction may be needed so that the statute reflects this intent.

[19] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1122; H.Rep. 99-426, pp. 731-734; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1222; S.Rep. 99-313, pp. 607-611; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 458-463 (Conference Report).

Lump-sum distributions

Under prior law, a lump-sum distribution from a qualified plan could qualify for special 10-year forward income averaging. In addition, the portion of a lump-sum distribution attributable to contributions prior to January 1, 1974, could qualify for treatment as long-term capital gains under prior law.

Basis recovery rules

Prior law provided special rules for the treatment of basis (e.g., employee contributions) when an individual received a distribution from a tax-favored retirement arrangement. If an amount was received before the annuity starting date (i.e., the date on which an amount was first received as an annuity), the individual was treated as first receiving the individual's own investment in the contract (basis), which was nontaxable, and then taxable income.

Present and prior law provide that, in the case of amounts received as an annuity on or after the annuity starting date, each payment received by an employee generally is treated, in part, as a return of the employee's basis and, in part, as taxable income. The portion of each payment treated as a return of employee's basis is that amount which bears the same ratio to each payment as the employee's total basis bears to the total expected payments over the period of the annuity. In the case of a straight-life annuity, the employee's life expectancy, as of the annuity starting date, is treated as the period over which the annuity is to be paid for purposes of computing the total expected return under the contract. Under prior law, if the employee died prior to the expiration of the employee's anticipated life expectancy, no deduction was provided for the employee's unrecovered basis. On the other hand, if an employee lived longer than the employee's life expectancy at the time benefits commence, the employee excluded from income an amount in excess of the employee's total basis.

In addition, under prior law, a special 3-year basis recovery rule applied under certain circumstances to annuity payments from qualified plans. Under the special rule, if an individual's first 3 years of annuity payments on and after the annuity starting date equaled or exceeded the individual's basis, all distributions were treated as a return of employee basis until all of the individual's employee contributions had been recovered. Thereafter, all distributions were fully taxable.

Constructive receipt under a tax-sheltered annuity

Under prior law, benefits under a tax-sheltered annuity were includible in gross income when received or made available.

Rollovers

Under prior and present law, a total or partial distribution of the balance to the credit of an employee under a qualified plan, a qualified annuity plan, or a tax-sheltered annuity may, under certain conditions, be rolled over, tax free, to an IRA or another qualified plan or annuity. A rollover of a partial distribution was permitted, under prior law, if (1) the distribution equaled at least 50 percent of the balance to the credit of the employee, (2) the distribution was not one of a series of periodic payments, and (3) the employee elected tax-free rollover treatment.

Further, under prior law, if the balance of an IRA was attributable solely to a tax-free rollover of the balance to the credit of the employee under a qualified plan, it generally could be distributed from the IRA and rolled over to another qualified plan unless the distribution was attributable to amounts contributed on behalf of certain owners to a qualified plan.

Net unrealized appreciation

Under prior and present law, a taxpayer is not required to include in gross income amounts received in the form of a lump-sum distribution to the extent that the amounts are attributable to net unrealized appreciation in employer securities. Such unrealized appreciation is includible in income when the securities are sold.

The special treatment of net unrealized appreciation applies only if a valid lump-sum distribution election is made, but disregarding the 5-plan years of participation requirement for lump-sum distributions.

Reasons for Change

The special 10-year averaging and capital gains provisions for lump-sum distributions (including lump-sum distributions before retirement) under prior law encouraged individuals to withdraw tax-favored funds from tax-favored retirement arrangements before retirement and were inconsistent with the policy of providing individuals with income at retirement. The original purposes of the capital gains and 10-year averaging provisions were to mitigate the effect of the progressive tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals generally to roll over distributions into an IRA. This results in the individual being taxed only as amounts are subsequently withdrawn from the IRA. Because rollovers are permitted, income averaging and capital gains treatment are less appropriate incentives to consume retirement monies, and are inappropriate with respect to distributions prior to age 59½. Thus, Congress believed that capital gains treatment should not be available and that income averaging should be available only on a limited basis and should be adjusted to reflect the decreased need for income averaging, given the tax structure in the Act.

Similarly, the basis recovery rules for distributions before retirement permitted the accelerated tax-free recovery of employee contributions and thus further encouraged the use of tax-favored retirement arrangements for nonretirement purposes. The 3-year basis recovery rule provided favorable tax treatment to a limited class of taxpayers, which was inequitable with respect to other taxpayers.

Explanation of Provisions

Overview

The Act generally (1) phases out long-term capital gains treatment over 6 years (except for certain grandfathered individuals); (2) eliminates 10-year forward averaging (except for certain grandfathered individuals) and allows 5-year forward averaging under more limited circumstances; (3) modifies the prior-law basis recovery rules for amounts distributed prior to a participant's annuity starting date; (4) repeals the special 3-year basis recovery rule; (5) modifies the general basis recovery rules for amounts paid as an annuity; (6) provides basis recovery rules for distributions from an IRA when an individual has also made nondeductible IRA contributions; (7) repeals the constructive receipt rule for tax-sheltered annuities; and (8) modifies the rules relating to rollovers of partial distributions.

10-year averaging and pre-1974 capital gains treatment

The Act generally repeals 10-year forward averaging, phases out pre-1974 capital gains treatment over a 6-year period, and makes 5-year forward averaging (calculated in the same manner as 10-year averaging under prior law) available for one lump-sum distribution received with respect to an employee on or after the employee attains age 59½. Under the 6-year phaseout of long-term capital gains treatment, the amount treated as long-term capital gains is subject to the rules and tax rates applicable generally to long-term capital gains under the Act.

Under the Act, a taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59½ [20] to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. However, only one such election on or after age 59½ may be made with respect to any employee. Thus, there is to be only one election on or after age 59½ with respect to amounts contributed on behalf of an employee. The same individual may make a 5-year averaging election with respect to amounts received as an employee and as a beneficiary of another employee, provided that the latter amounts are received on or after such other employee had attained age 59½. An income averaging election (other than an election made after the employee attains age 59½) made prior to the effective date of the modifications does not preclude the 1 income-averaging election permitted with respect to an employee under the Act.

In the case of a distribution to a trust or estate, an income averaging election is available only if the employee had attained age 59½.[21]

In addition, the Act provides a special transition rule under which, with respect to an employee who has attained age 50 by January 1, 1986, any individual, trust, or estate is permitted to make one election with respect to such employee to use 5-year averaging (under the new tax rates) or 10-year averaging (under the prior-law tax rates, taking into account the prior-law zero bracket amount) with respect to a single lump-sum distribution, without regard to whether the employee has attained age 59½.[22] As under prior law, this election may be made with respect to the entire lump-sum distribution or with respect solely to that portion that is not eligible for capital gains treatment. An election under the special transition rule to use income averaging on a lump-sum distribution received before, on, or after the employee attains age 59½ eliminates the availability of an income averaging election on or after age 59½ under the general rule.

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[20] A technical correction may be needed so that the statute reflects this intent.

[21] A technical correction may be needed so that the statute reflects this intent.

The Act also provides a special transition rule under which the individual, trust, or estate[23] receiving a distribution with respect to an employee who attained age 50 by January 1, 1986, may elect capital gains treatment with respect to a lump-sum distribution without regard to the 6-year phaseout of capital gains treatment. Under the Act, if an individual who has attained age 50 by January 1, 1986, elects, pursuant to this transition rule, to retain the capital gains character of the pre-1974 portion of a lump-sum distribution, the capital gains portion is taxed at a rate of 20 percent. The 20-percent rate applies to all taxpayers, regardless of the maximum effective capital gains rate under prior law.

Basis recovery rules

In general.—The Act modifies the basis recovery rules applicable to distributions from plans to which after-tax employee contributions have been made by (1) eliminating the 3-year basis recovery rule for distributions on or after the annuity starting date, and (2) requiring, with respect to distributions prior to the annuity starting date, that basis be recovered on a pro-rata basis. The Act also provides rules governing the recovery of basis on distributions from an IRA if an individual has made nondeductible IRA contributions.

Pre-annuity starting date distributions.—The Act modifies the basis recovery rules for pre-annuity starting date distributions to provide for the pro-rata recovery of basis. With respect to a pre-annuity starting date distribution, a participant is entitled to exclude an amount determined by multiplying the amount of the payment by the ratio of the participant's basis to the total value of the participant's accrued benefit (or account balance) under the plan as of the date of distribution or as of such other time as the Secretary may prescribe. The Secretary is authorized to prescribe appropriate rules for estimating the amounts referred to in the prior sentence if precise calculation would be unjustifiably burdensome.

If an employee is only partially vested in the portion of benefits attributable to employer contributions (for example, in the case of a plan with a graded vesting schedule), only the portion of the employee's accrued benefit that has not yet vested is not taken into account in determining the total value of the participant's accrued benefit.

In the case of an employee who, on separation from service, receives the entire balance of the employee's contributions (plus interest, if any) and, as a result of the cashout, forfeits the right to any other retirement benefit under the plan, the amount distributed is treated as a nontaxable return of employee contributions and taxable interest, if any.

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[22] A technical correction may be needed so that the statute reflects this intent.

[23] A technical correction may be needed so that the statute reflects this intent.

Post-annuity starting date distributions.—With respect to amounts received in the form of an annuity on or after the annuity starting date, the special 3-year basis recovery rule is repealed. An employee is to include in income a portion of each payment made on or after the employee's annuity starting date under the general rule.

The Act limits the total amount that an employee may exclude from income to the total amount of the employee's basis. In addition, if benefits cease prior to the date the basis has been fully recovered, the amount of unrecovered basis is allowed as a deduction to the annuitant for his or her last taxable year. For purposes of the provisions of the Code relating to net operating losses, the deduction is treated as related to a trade or business of the annuitant.

If an employee dies and benefit payments continue to be made to the employee's beneficiary, the beneficiary recovers the remaining basis with respect to the employee under the general rule.

As under prior law, with respect to distributions that are not received in the form of an annuity and that are paid on or after the annuity starting date, the amount received is deemed to be attributable first to income on the contract.

Further, it is anticipated that the Secretary will consider developing simplified rules for calculating the exclusion ratio applicable to an annuity.

Separate contract treatment.—Under the Act, employee contributions to a defined contribution plan or a separate account of a defined benefit plan [24] (and the income attributable thereto) may be treated as a separate contract for purposes of section 72.

Thus, under the Act, if an employee withdraws amounts from such a separate contract either before or after the employee's annuity starting date,[25] then for tax purposes, the distribution will be considered to be part nontaxable, i.e., a return of employee contributions, and part taxable, i.e., a distribution of earnings on those contributions. The distribution will not, however, be considered to be attributable to employer contributions. If an employee withdraws all amounts attributable to employee contributions and such amount is less than the total employee contributions, the employee may recognize a loss.

A plan may designate the contract from which a distribution is made either expressly through a plan provision or in practice by crediting a particular contract when a distribution is made under the plan. Alternatively, a participant can be permitted to designate the contract from which a distribution is made.

Individual retirement accounts.—The basis recovery rules for distributions from an IRA if an individual has made nondeductible IRA contributions generally are similar to the rules applicable to distributions from a qualified plan. See the description in Part A.1., above.

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[24] A technical correction may be needed so that the statute reflects this intent.

[25] A technical correction may be needed so that the statute reflects this intent.

Constructive receipt under a tax-sheltered annuity

Under the Act, distributions under a tax-sheltered annuity are includible in income when received. The prior-law rule, under which benefits under a tax-sheltered annuity were includible in income when received or made available, is repealed.

Rollovers

The Act modifies the rules relating to rollovers of partial distributions. Under the Act, partial distributions may be rolled over only if the distribution would satisfy the requirements for a lump-sum distribution if at least 50 percent of the balance to the credit of an employee is used rather than the balance to the credit of the employee in applying the test for lump-sum distribution treatment. Thus, generally a partial distribution may be rolled over if the distribution is due to the death of the employee, is on account of the employee's separation from service (including the separation from service of a self-employed individual), or is made after the employee has become disabled. Thus, a partial distribution may not be rolled over if the distribution is due solely to the participant's attainment of age 59½. The requirement that a partial distribution not be one of a series of periodic payments is eliminated.

For purposes of determining whether a partial distribution may be rolled over, the 5-plan years of participation and the election requirements applicable to lump-sum distributions do not apply (secs. 402(c)(4)(B) and (H)).[26] However, the rule aggregating plans of the same kind does apply for purposes of determining whether the amount distributed constitutes 50 percent of the balance to the credit of an employee (sec. 402(e)(4)(C)).

In addition, in determining whether a distribution is at least 50 percent of the balance to the credit of an employee, prior distributions to the employee are disregarded.

Under a special rule, a distribution in satisfaction of the diversification requirements applicable under the Act to employee stock ownership plans (ESOPs) may be rolled over even if the distribution does not otherwise qualify for rollover treatment.

The Act contains a special rule permitting certain amounts deposited in certain financially distressed financial institutions to be rolled over notwithstanding that the rollover does not occur within 60 days of the date of the original distribution. Under this rule, the 60-day period does not include periods while the deposit is frozen. In addition, the individual has a minimum of 10 days after the release of the frozen deposit to complete the rollover. This frozen deposit rule applies to amounts distributed to an employee within 60 days before the date the account was frozen.[27]

Net unrealized appreciation

Under the Act, a taxpayer may elect to waive the special treatment of net unrealized appreciation in employer securities with respect to the lump-sum distribution. The election is to be made on the tax return on which the distribution is required to be included in gross income.[28]

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[26] A technical correction may be needed so that the statute reflects this intent.

[27] A technical correction may be needed so that the statute reflects this intent.

An election to waive the special treatment of net unrealized appreciation does not preclude an election for income averaging.[29]

Effective Dates

The provisions are generally effective for distributions after December 31, 1986.

The basis recovery rules are generally effective with respect to distributions received after December 31, 1986. The repeal of the 3-year basis recovery rule is effective with respect to all payments after July 1, 1986, to individuals whose annuity starting date is after July 1, 1986. For example, assume that a plan provides that, if an employee retires by the last day of a month, the employee's annuity starting date is the first day of the following month. If an employee retired under the plan by June 30, 1986, the repeal of the 3-year basis recovery rule does not apply to the employee because the employee's annuity starting date is not after July 1, 1986. This result occurs even if the employee does not actually receive an annuity payment on July 1, 1986, as long as the first annuity payment received by the employee is for the period commencing July 1, 1986.

In the case of an employee whose annuity starting date was after July 1, 1986, and before October 22, 1986, no withholding obligation existed with respect to the annuity payments because, at the time of the payments, it was not reasonable to believe that the amounts were includible in income (sec. 3405(d)(1)(B)(ii)).

In the case of an employee whose annuity starting date was before July 2, 1986, but whose annuity is subsequently modified after July 1, 1986 (e.g., because of a change in the payout schedule or because the employee accrued additional benefits), then such modified annuity does not give rise to a new annuity starting date. This rule applies solely with respect to the repeal of the 3-year basis recovery rule and applies notwithstanding the general rule relating to modifications of an annuity (see Treas. reg. 1.72-11(e)).

Under the Act, in the case of a plan that, on May 5, 1986, permitted withdrawal of any employee contributions before separation from service of the employee, the modifications in the basis recovery rules for distributions prior to the annuity starting date apply only to the extent that the amount distributed exceeds the employee's basis as of December 31, 1986.

The provision limiting the income exclusion to the amount of the employee's basis applies to individuals whose annuity starting date is after December 31, 1986. The provision permitting a deduction for unrecovered basis when payments cease applies to individuals whose annuity starting date is after July 1, 1986.[30]

The repeal of the constructive receipt income inclusion rule for tax-sheltered annuities is effective for taxable years beginning after December 31, 1985.

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[28] A technical correction may be needed so that the statute reflects this intent.
[29] A technical correction may be needed so that the statute reflects this intent.
[30] A technical correction may be needed so that the statute reflects this intent.

The new rules with respect to partial distributions are effective with respect to amounts distributed after December 31, 1986. The special rule for frozen deposits is generally effective with respect to distributions after the date of enactment. With respect to amounts which were frozen and released prior to October 22, 1986, the rollover is required to be completed within 60 days following the date of enactment.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1,116 million in 1987, $1,800 million in 1988, $2,050 million in 1989, $2,077 million in 1990, and $2,106 million in 1991.

4. Treatment of loans (sec. 1134 of the Act and sec. 72(p) of the Code)[31]

Prior Law

An individual is permitted, under present and prior law, to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) provided the loan bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of employees who are officers, shareholders, or highly compensated. However, no loan was permitted under the Employee Retirement Income Security Act of 1974 (ERISA) under prior law from a qualified plan to an owner-employee (i.e., a sole proprietor or more than 10-percent partner).[32] Interest paid on a loan from a qualified plan was deductible without restriction under prior law.

Subject to certain exceptions, a loan to a plan participant is treated as a taxable distribution of plan benefits under present and prior law. An exception to this general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $50,000 or (2) the greater of $10,000 or one-half of the participant's accrued benefit under the plan. This exception applies only if the loan is required, by its terms, to be repaid within 5 years or, if the loan is used to acquire or substantially improve a principal residence of the participant or a member of the participant's family, within a reasonable period of time.

Reasons for Change

The rules governing the tax treatment of loans from certain tax-favored plans were intended to limit the extent to which an employee may currently use assets held by a plan for nonretirement purposes and to ensure that loans are actually repaid within a reasonable period. However, Congress was concerned that the prior-law rules did not prevent an employee from effectively maintaining a permanent outstanding $50,000 loan balance through the use of balloon repayment obligations and bridge loans from third parties.

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[31] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1134; H.Rep. 99-426, pp. 734-735; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1234; S.Rep. 99-313, pp. 618-619; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 463-465 (Conference Report).

[32] ERISA sec. 408(d).

In addition, the prior-law rule permitting home loans with repayment periods extending beyond 5 years for family members of the employee and for certain improvements on existing principal residences was overly broad and difficult to apply. Congress believed that the favorable tax treatment of amounts set aside in qualified plans should be targeted at providing employees with retirement income security, and that any exceptions to this general policy should be narrowly limited.

Explanation of Provision

In general, the Act modifies the exception to the income inclusion rule by reducing the $50,000 limit on a loan by the participant's highest outstanding loan balance during the preceding 12-month period. Under the Act, a loan, when added to the outstanding balance of all other loans from all plans of the employer, cannot exceed $50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the 1-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made.

For example, a participant with a vested benefit of $200,000 borrows $30,000 from a plan on January 1. On November 1, the participant wants to borrow an additional amount without triggering a taxable distribution. At that time, the outstanding balance on the first loan is $20,000. The maximum amount that the participant can borrow is $20,000, i.e., $50,000 - [$20,000 + ($30,000 - $20,000)].

The Act restricts the extended repayment period permitted for purchase or improvement of a principal residence to the purchase of the principal residence of the participant. Plan loans to improve an existing principal residence, to purchase a second home, and to finance the purchase of a home or home improvements for other members of the employee's family are subject to the 5-year repayment rule.

The Act requires that plan loan repayments (principal and interest) be amortized in level payments, made not less frequently than quarterly, over the term of the loan.

Congress intended that the level amortization requirement does not apply to a period when the employee is on a leave of absence without pay for up to 1 year. In addition, the requirement does not preclude repayment or acceleration of the loan prior to the end of the commitment period or the use of a variable interest rate. Thus, for example, the provision does not preclude a plan from requiring full repayment upon termination of employment.

The Act provides for the disallowance of the deduction for interest paid by (1) all employees on loans secured by elective deferrals (or the income attributable thereto) under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account, and (2) key employees with respect to loans from any qualified plan or tax-sheltered annuity or custodial account. For this purpose, matching contributions and nonelective contributions made by the employer are not considered to be elective deferrals. Thus, even if such contributions are taken into account for purposes of the special nondiscrimination rules applicable to qualified cash or deferred arrangements, interest paid on loans secured by such contributions is not rendered nondeductible by this provision.

No basis is created in a participant's account with respect to any nondeductible interest paid on a loan from a qualified plan or tax-sheltered annuity or custodial account.

Effective Dates

The provisions are generally effective with respect to loans made after December 31, 1986. Any renegotiation, extension, renewal, or revision after December 31, 1986, of an existing loan is treated as a new loan on the date of such renegotiation, etc.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually for 1987-1991.

D. Limits on Tax Deferral Under Qualified Plans

1. Adjustments to limitations on contributions and benefits under qualified plans (sec. 1106 of the Act and sec. 415 of the Code)[1]

Prior Law

In general

Prior and present law (sec. 415) provide overall limits on contributions and benefits under qualified pension, profit-sharing, and stock bonus plans, qualified annuity plans, tax-sheltered annuities, and simplified employee pensions (SEPs). The overall limits apply to all such contributions and benefits provided to an individual by any private or public employer or by certain related employers.

Defined contribution plans

Under a defined contribution plan, the qualification rules limit the annual additions with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000 (sec. 415(c)).[2] Increased limits (catch-up limits) are provided for certain employees who participate in tax-sheltered annuity programs maintained by specified employers.

Under prior law, the annual addition under a defined contribution plan consisted of employer contributions, reallocated forfeitures, certain employee contributions, and certain contributions for post-retirement medical benefits. The amount of employee contributions taken into account in computing the annual addition under a defined contribution plan is the lesser of (1) one-half of the employee contributions, or (2) employee contributions in excess of 6 percent of compensation.[3] Under prior law, therefore, if total employee contributions did not exceed 6 percent of compensation, no employee contributions were counted as annual additions.

Defined benefit pension plans

In general.—Under prior and present law, the limit on the annual benefit provided by a defined benefit pension plan is generally the lesser of (1) 100 percent of average compensation, or (2) $90,000.[4]

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1103; H.Rep. 99-426, pp. 737-749; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1206; S.Rep. 99-313, pp. 620-631; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 466-479 (Conference Report).

[2] For purposes of applying the limit on annual additions, all defined contribution plans of an employer are treated as a single defined contribution plan.

[3] Under prior law, deductible employee contributions were not taken into account in computing annual additions, but were instead coordinated with the individual's deductible IRA contributions.

[4] For purposes of applying the limit on annual benefits, all defined benefit pension plans of an employer are treated as a single defined benefit pension plan. Under transition rules provided by ERISA and by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the dollar limit on annual benefits may exceed $90,000.

Early retirement benefits.—Under prior law, if retirement benefits commenced before age 62, then the dollar limit (but not the 100 percent of compensation limit) generally was reduced so that it was the actuarial equivalent of an annual benefit of $90,000 commencing at age 62. In no event, however, was the dollar limit applicable to benefits commencing at or after age 55 less than $75,000, under prior law.

If retirement benefits commenced before age 55, then, under prior law, the dollar limit was actuarially reduced so that it was the greater of (1) the actuarial equivalent of a $75,000 annual benefit commencing at age 55, or (2) the actuarial equivalent of the applicable dollar limit at age 62. The $75,000 early retirement limit was not adjusted for cost-of-living or wage increases.

If retirement benefits under a defined benefit pension plan begin after age 65, then, under prior law, the $90,000 limit was increased so that it was the actuarial equivalent of an annual benefit of $90,000 beginning at age 65.

Under prior and present law, the limit on annual benefits under a qualified defined benefit pension plan do not prohibit an employee from retiring prior to age 62, and they do not mandate actuarial reductions in plan benefits commencing prior to age 62 where the limits are not exceeded. Similarly, the limit does not require that a plan provide increased benefits merely because benefits commence after age 65.

Eligibility to receive maximum benefits.—Under prior law, the limits on benefits were phased in for participants who had completed fewer than 10 years of service. Prior law provided that the dollar limit and the percentage limit were reduced by 10 percent per year for each year by which the number of years of service is less than 10. For example, benefits commencing at or after age 62 with respect to a participant who completed only three years of service could not exceed the lesser of (1) 30 percent of compensation (3/10 times 100 percent of average compensation), or (2) $27,000 ($27,000 is 3/10 of the $90,000 dollar limit).

Prior law also applied the reduction to the de minimis benefit limit applicable to defined benefit pension plans. Under prior and present law, the de minimis benefit limit provides that a plan does not fail to meet the limit on annual benefits if (1) the participant's annual benefit does not exceed a specified amount, and (2) the participant has not, at any time, participated in a defined contribution plan maintained by the employer. Generally, the specified amount is $10,000. For a participant who has not completed 10 years of service with the employer, however, the $10,000 amount is reduced by $1,000 for each year by which the number of the participant's years of service is less than 10. For example, the de minimis benefit payable with respect to a participant who has only 3 years of service may not exceed $3,000 (3/10 of $10,000) under prior and present law.

Retirement age under Social Security Act—Under prior and present law, the retirement age under the Social Security Act with respect to old-age benefits (sec. 216(l) of the Social Security Act) is scheduled to increase to age 67 from age 65 over a period of 20 years. The retirement age for an individual who attains age 62 before the year 2000 is age 65. For an individual who attains age 62 after December 31, 1999, the retirement age increases, in increments, to age 67. For a particular individual, therefore, the retirement age may be age 65 or 66 plus a number of months, depending upon the date the individual attains age 62.

Under prior and present law, an individual who has retired may begin receiving benefits under the Social Security Act at or after age 62. However, in the case of an individual who has not attained the social security retirement age, the amount of benefits payable is reduced until the individual attains the social security retirement age.

Cost-of-living increases

Beginning in 1988, the $30,000 and $90,000 limits were scheduled under prior law to be adjusted for post-1986 cost-of-living increases.

Includible compensation

Under prior law, a limit was provided under certain plans on the amount of any participant's compensation that could be taken into account under the plan. In the case of a top-heavy plan or a simplified employee pension (SEP), the limit on includible compensation was $200,000 (adjusted at the same time and in the same manner as the adjustments to the dollar limit on annual additions under a defined contribution plan). This limit on includible compensation applied for purposes of determining (1) the dollar limits on contributions and benefits (sec. 415), and (2) whether a plan met the nondiscrimination requirements (secs. 401(a)(4) and 408(k)(3)).

Reasons for Change

Congress was concerned that prior law tended to encourage early retirement because the dollar limitations on annual benefits were more generous for individuals who retire before the social security retirement age (presently, age 65) than the limits for individuals who retire at or after the social security retirement age because of the manner in which the dollar limits were actuarially reduced for early retirement.

Congress also focused on the relationship between the dollar limit for defined benefit pension plans and the dollar limit provided for defined contribution plans. Congress concluded that prior law unduly favored defined contribution plans even though defined benefit pension plans can provide better overall retirement income security. Congress believed that the relationship between the limits should be adjusted more favorably toward defined benefit pension plans because (1) those plans can provide a level of benefits that can be predicted by participants long before retirement, (2) the participants in defined benefit pension plans can be protected against investment losses, and (3) the plans can provide better protection against inflation. In addition, defined benefit pension plans can be designed to fit in a coherent retirement program that replaces a targeted portion of a participant's compensation.

Congress found it appropriate to provide for a gradual change in the ratio between the defined benefit and defined contribution limits. The change, which defers inflation adjustments for annual additions under defined contribution plans, was intended to increase the attractiveness of defined benefit pension plans.

In addition, Congress was concerned that the rule requiring reduced limits on benefits payable to participants with fewer than 10 years of service was not effectively limiting benefits for highly paid employees with short periods of plan participation. Congress was aware that some employers were able to arrange the time for establishment of a defined benefit pension plan (or an increase in benefits under a plan) to coincide with the projected retirement of one or more of the employer's highly compensated employees. The effect of this delay was to avoid providing a comparable level of benefits to other employees who retired before the highly compensated employees. Further, if the employer ceased to do business after the retirement of a highly paid employee, then other employees might have been denied the opportunity to earn comparable pension benefits.

Congress believed that the limits should be structured to encourage employers to establish plans earlier and to increase benefits sooner by providing that the dollar limit on annual benefits is phased in over a period of 10 years of participation (rather than service).

Explanation of Provisions

Overview

The Act revises the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs. The Act generally conforms the age used in the computation of the limit on annual benefits to the retirement age in effect under the Social Security Act. Generally, under the 1986 Act, if the retirement benefit under a defined benefit pension plan begins before the retirement age under the Social Security Act (presently, age 65), then the dollar limit on annual benefits ($90,000 for 1987) is reduced under rules corresponding to those applicable to the primary insurance amount paid before the retirement age under the Social Security Act. Under transition rules provided by the 1986 Act, the current accrued benefit of a plan participant is not affected by the reduction to reflect early retirement.

In addition, the Act (1) delays any inflation adjustment to the dollar limit on annual additions under a defined contribution plan until the limit on annual benefits under a defined benefit pension plan, as adjusted for inflation, exceeds $120,000; (2) provides special rules with respect to plans of governmental employers and tax-exempt employers, and with respect to a qualified merchant marine plan; (3) provides special rules for police, firefighters, and airline pilots; (4) permits a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary retirement benefit under the plan; (5) treats all employee contributions as annual additions under a defined contribution plan; (6) modifies the rules relating to the phase-in of the limits on annual benefits under a defined benefit pension plan; (7) provides that a plan may incorporate the limits under section 415 by reference; and (8) expands the class of employers whose employees are entitled to the special catch-up elections applicable to tax-sheltered annuity programs.

Defined benefit pension plans

Dollar limits on benefits adjusted to conform to Social Security Act

In general.—The Act generally conforms the age taken into account in determining the limit on early retirement benefits under a qualified defined benefit pension plan to the age taken into account for determining early retirement benefits under the Social Security Act. In addition, the $75,000 floor for benefits commencing at or after age 55 is repealed.

Under the Act, the dollar limit on the annual benefit that may be provided by a qualified defined benefit pension plan ($90,000 for 1987) is reduced if benefits commence before the social security retirement age. The Act defines the social security retirement age by reference to the age taken into account under the Social Security Act for similar purposes.

The provision does not reduce the 100-percent of compensation limit applicable to annual benefits under a defined benefit pension plan. Also, the provision does not affect either the time at which a plan participant may retire or the employer's assumption (for funding purposes) with respect to the time at which participants will retire.

Social security retirement age.—Under the Act, the social security retirement age is the age used as the retirement age under the Social Security Act with respect to old-age benefits, with certain modifications. The primary modification is that the social security retirement age increases from age 65 to age 67 in whole years. Thus, in the case of a plan participant who attains age 62 before January 1, 2000, the social security retirement age is age 65; (2) in the case of a plan participant who attains age 62 after December 31, 1999, and before January 1, 2017, the social security retirement age is age 66; and (3) in the case of a plan participant who attains age 62 after December 31, 2016, the social security retirement age is age 67.

Computation of early retirement reduction.—Under the Act, the dollar limit on annual benefits is reduced if benefits commence before the social security retirement age. The reductions provided for benefits commencing between age 62 and the social security retirement age are designed to be consistent with the reductions provided by the Social Security Act for benefits commencing during that period.

For a participant who has attained age 62 but who has not attained the social security retirement age when benefits commence, the dollar limit is to be reduced by a set percentage for each month by which benefits commence before the social security retirement age. For months between 65 and the social security retirement age, the percentage reduction is 5/12 of 1 percent per month. For months between age 62 and age 65, the percentage reduction is 5/9 of 1 percent per month.

Under the provision, for example, if a participant's benefit commences at age 62, and if the participant's social security retirement age is 67, then the limit on annual benefits is reduced by 30 percent (the sum of 20 percent (5/9 x 36 months for the months between age 62 and age 65), and 10 percent (5/12 x 24 for the months between age 65 and age 67)).

For benefits commencing prior to age 62, the limit on the annual benefit is reduced to the actuarial equivalent of the limit applicable at age 62. As under prior law, the actuarial reduction is computed using an assumed interest rate that is not less than the greater of 5 percent or the rate specified in the plan for purposes of determining early retirement benefits.

The Act also modifies the prior-law rule permitting an increased limit with respect to benefits commencing after attainment of age 65. Under the Act, if retirement benefits provided by a defined benefit pension plan begin after the social security retirement age, the dollar limit is increased so that it is the actuarial equivalent of the dollar limit applicable to a benefit beginning at the social security retirement age. As under prior law, the increase is to be computed using an interest rate assumption not higher than the lesser of 5 percent or the rate specified in the plan.

Special rules for certain plans

In general.—The Act provides special rules applicable to a governmental plan (sec. 414(d)), to a plan maintained by a nongovernmental organization that is exempt from income tax, and to a qualified merchant marine plan. For those plans, the Act continues the rules of prior law with respect to the limits on annual benefits. Under the Act, a plan is a qualified merchant marine plan if (1) the plan was in existence on January 1, 1986, and (2) the participants in the plan are merchant marine officers holding licenses issued by the Secretary of Transportation (Title 45 of the United States Code).

Accordingly, the actuarial reduction of the limit on annual benefits for early retirement does not reduce the limit below (1) $90,000 for benefits commencing on or after the participant has attained age 62, (2) $75,000 for benefits commencing on or after the participant has attained age 55, or (3) the actuarial equivalent of $75,000 commencing at age 55 for benefits commencing before age 55.

Police and firefighters.—In addition, the Act provides a special floor on the annual limit on benefits with respect to certain police and firefighters. Under the Act, in the case of a qualified participant, the special rules for governmental plans apply and, in addition, the reduction provided for benefits payable before age 62 under prior law is not to reduce the dollar limit on annual benefits below $50,000 at any age. The Act provides that the $50,000 limit is to be adjusted for inflation at the same time and in the same manner provided for the adjustment of the general limit on annual benefits under a defined benefit pension plan (sec. 415(d)).

Under the Act, a qualified participant is a participant in a defined benefit pension plan maintained by a State or political subdivision of a State if the period of service taken into account in determining the participant's benefit under the plan includes at least 20 years of the participant's service as (1) a full-time employee of any police department or fire department that is organized and operated by the State or political subdivision of a State maintaining the plan to provide police protection, firefighting services, or emergency medical services for any area within the jurisdiction of that State or subdivision, or (2) a member of the Armed Forces of the United States.

Special rules for airline pilots.—The Act provides that in the case of a commercial airline pilot, the $75,000 floor provided by prior law is to apply. The Act further provides that if, as of the time a participant retires, regulations prescribed by the Federal Aviation Administration require an individual to separate from service as a commercial airline pilot after attaining an age of at least age 60, and before the social security retirement age, then the age of required separation is substituted for the social security retirement age in applying the limit on annual benefits to benefits that commence before the age of required separation.

The Act also provides that these rules do not apply to a commercial airline pilot who separates from service before age 60. Instead, the limit on annual benefits for such an individual is determined under the rules applicable to governmental plans. Accordingly, for those pilots, the actuarial reduction of the limit on annual benefits is not to reduce the limit below (1) $75,000 for benefits commencing on or after the participant has attained age 55, or (2) the actuarial equivalent of $75,000 commencing at age 55 for benefits commencing before the participant has attained age 55.

Under the Act, the special rule for commercial airline pilots is limited to an individual whose service as a commercial airline pilot constitutes substantially all of the service to which the benefit relates.

Qualified cost-of-living arrangement

In general

The Act permits a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit under the plan. If the arrangement qualifies, then an employee contribution under the arrangement is not to be treated as an annual addition in applying the separate limit on annual additions under defined contribution plans (sec. 415(c)), but is to be treated as an annual addition for purposes of applying the combined plan limit (sec. 415(e)). Further, under a qualified arrangement, the benefit attributable to an employee's contribution is to be treated as a benefit derived from employer contributions for purposes of applying the limit on annual benefits (sec. 415(b)). Under the Act, a qualified cost-of-living arrangement is required to comply with the dollar limits, election procedures, and nondiscrimination requirements of the Act. Special rules apply to key employees.

Treatment as accrued benefit

Congress intended that the right of a plan participant to the employer-derived portion of a qualified cost-of-living benefit is to be regarded as a part of the employee's accrued benefit under the plan, subject to the vesting and benefit accrual requirements of section 411 (including sec. 411(d)(6)). Thus, an employer may reduce or eliminate the employer contribution under a qualified cost-of-living arrangement only with respect to benefits not yet accrued.

The employer-derived portion of the cost-of-living benefit need not be provided to an employee who fails to satisfy the applicable conditions for receipt of the benefit, including any required employee contributions. Further, the cost-of-living benefit need not be provided to an employee who has separated from service and received a distribution without making the required contributions for the cost-of-living benefit. The employee could, however, return to service and buy back the availability of the cost-of-living benefit by proper repayment of the cashed-out benefit.

Other requirements

Availability.—Under the Act, cost-of-living increases are to be available on the same terms for all participants. Thus, a greater subsidy could not be provided for employees who work until retirement than to those who separate from service with vested benefits prior to retirement.

Limit requirement.—A qualified cost-of-living arrangement satisfies the limit requirement provided by the Act if it (1) limits cost-of-living adjustments to those cost-of-living increases occurring after the annuity starting date, and (2) bases the cost-of-living adjustment on average cost-of-living increases determined by reference to one or more indices prescribed by the Secretary, except that the plan can provide a minimum increase for each year of 3 percent of the original retirement benefit or 3 percent of the retirement benefit as adjusted under the cost-of-living arrangement in prior years.[5]

Election requirement.—A cost-of-living arrangement meets the election requirements provided by the Act if it provides that participation in the qualified cost-of-living arrangement is elective and permits participants to make an election on or after the earlier of (1) the year in which the participant attains the age at which retirement benefits are first available under the defined benefit pension plan, or (2) the year in which the participant separates from service. Of course, the plan could also permit elections to be made at other times as long as the right to make an election at such other times is available to all participants.[6]

Nondiscrimination requirement.—A cost-of-living arrangement does not meet the nondiscrimination rules provided by the Act if the arrangement discriminates in favor of highly compensated employees with respect to participation.

Special rule for key employees

Under the Act, key employees generally are precluded from participating in a qualified cost-of-living arrangement. However, in a plan that is not top heavy, officers who are key employees solely by reason of their status as officers may participate. For purposes of this rule, the term "key employee" has the meaning provided under the rules for top-heavy plans (sec. 416(i)).

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[5] A technical correction may be needed so that the statute reflects this intent.

[6] A technical correction may be needed so that the statute reflects this intent.

Treatment of contributions to qualified cost-of-living arrangements

Under the Act, an employee contribution made to a qualified cost-of-living arrangement will not be treated as an annual addition for purposes of the limit on annual additions under defined contribution plans (sec. 415(c)), but will be treated as an annual addition for purposes of applying the combined plan limit (sec. 415(e)). Any benefit under a qualified cost-of-living arrangement that is allocable to an employer contribution that was transferred from a defined contribution plan to which section 415(c) applied is treated as a benefit derived from an employee contribution for purposes of section 415(b), and neither section 415(e) nor (c) applies to such contribution by reason of the transfer.

The Act provides that employee contributions to a qualified cost-of-living arrangement are subject to the nondiscrimination rules generally applicable to employee contributions (secs. 401(a)(4) and 401(m)).

Treatment of employee contributions as annual additions

The Act repeals the prior-law rule under which only a portion of employee contributions was treated as annual additions and provides that all employee contributions are included in the annual addition for purposes of the dollar limits on contributions and benefits.

Eligibility to receive maximum benefits

In general.—Under the Act, a reduced dollar limit applies to participants who have completed fewer than 10 years of participation in a defined benefit pension plan (sec. 415(b)(5)). With respect to such participants, the dollar limit is determined by multiplying the otherwise applicable dollar limit by a fraction. The numerator of the fraction is the number of years (including a fractional year) of participation in the plan completed by the employee. The denominator of the fraction is 10. For example, for a participant who has completed 3 years of participation under a plan, the maximum annual benefit that could be provided by the plan would be the lesser of 100 percent of compensation (reduced by 10 percent for each year of service less than 10), or $27,000 (3/10ths of $90,000). This phase-in rule provided by the Act does not prevent a plan from assuming future participation by employees for funding purposes as long as the assumptions are reasonable.

Compensation and benefits limits.—The Act continues prior law with respect to the computation of the 100-percent of compensation limit (sec. 415(b)(1)(B)) and the $10,000 de minimis limit (sec. 415(b)(4)). Under the Act, those limits are to be determined on the basis of years of service rather than years of participation.

Benefit structures.—Under the Act, to the extent provided by Treasury regulations, the reduction based on years of participation is to be applied separately with respect to each change in the benefit structure of a plan by a plan amendment or otherwise as if such change is a new plan. This phasein for each change in benefit structure begins on the date a plan amendment creating the change is effective. Accordingly, an amendment improving the benefit formula of a plan may increase benefits by up to 1/10 of the applicable dollar limit on annual benefits for each year of participation completed by a participant after the amendment is effective. Benefit increases under a second amendment within 10 years of a prior amendment increasing benefits are, in addition to being subject to their own limit, subject to the limit under the phasein triggered by the prior amendment (along with benefit increases under the prior amendment).

For example, assume that a plan amendment is effective on January 1, 1987, changing the benefit structure of a plan prospectively by increasing benefits. Assume further that, under the prior plan structure, participant A would have accrued a $10,000 benefit in 1987 (none of which is subject to the phasein) and that, under the amended structure, A accrues $15,000 in 1987. The increase of $5,000 is less than $9,000 (1/10 of the $90,000 limit in effect in 1987) and thus is not reduced on account of the phasein under the Act.

In addition, assume that the benefit structure is amended again in 1988, so that A accrues $20,000 in 1988. Assume that the dollar limit on benefits for 1988 is $90,000. Without the second amendment, A would have accrued $15,000 (the original benefit accrual of $10,000 plus the $5,000 additional accrual under the first amendment); without the first amendment, A would have accrued $10,000. In this situation, applying the limit requires a two-step process. With regard to the original benefit structure, the limit is $18,000, i.e., 2/10 of the $90,000 limit. (Assume, for convenience, that the dollar limit in 1988 is $90,000.) The total increases from the original benefit structure are $5,000 in 1987 and $10,000 in 1988 for a total of $15,000. This is less than $18,000 and is thus permissible. The second step is to test the plan with respect to the 1987 benefit structure. The total benefit increase from this structure is $5,000 (i.e., $20,000 - $15,000), which is less than $9,000 (1/10 of the $90,000 limit) and thus does not cause the limit on benefits to be violated.

Congress expected the Secretary of the Treasury to prescribe regulations defining those changes in benefit structure for which a new 10-year period of participation would not be required. Congress did not intend the phasein for benefit increases to apply to benefit improvements due to updating of compensation in a career average pay plan, cost-of-living increases for retirees, the beginning of a new collective bargaining cycle, or other reasonable benefit improvements that are not primarily for highly compensated employees. Thus, Congress expected that the Secretary will apply a concentration test under which the phase-in limits will not apply to a benefit increase if the resulting increase in benefits is not primarily for highly compensated employees. In addition, Congress anticipated that the Internal Revenue Service will provide rules permitting the tacking of participation under separate plans in circumstances not inconsistent with the purposes of the phasein.

It is not intended that plan provisions which merely incorporate cost-of-living increases (within the meaning of sec. 415(d)) or compensation changes (as in a final pay plan) are to be treated as changes in a plan's benefit structure for which a 10-year phasein is required. The Act authorizes the Secretary of the Treasury to issue regulations for the application of this rule in situations involving plan mergers or spin-offs.

Cost-of-living increases

The Act retains the prior-law cost-of-living adjustments for the defined benefit pension plan dollar limit (sec. 415(d)). Under the Act, however, cost-of-living adjustments to the $30,000 limit on annual additions under a defined contribution plan are temporarily suspended until that limit is equal to 25 percent of the defined benefit pension plan dollar limit.

As under prior law, anticipated cost-of-living adjustments to the dollar limits on annual benefits may not be taken into account under the rules relating to the deduction allowed for employer contributions to a qualified plan.

Includible compensation

The Act extends the prior-law $200,000 limit on the amount of compensation that could be taken into account under a top-heavy plan or a SEP to all qualified plans (sec. 401(a)(17)). This limit on includible compensation will be adjusted, beginning in 1990, at the same time and in the same manner as the dollar limit on benefits under a defined benefit pension plan. The $200,000 limit applies, under the Act, for most purposes, including the provisions relating to nondiscrimination requirements (e.g., secs. 401(a)(4), 401(a)(5), 401(k)(3), 401(l), 401(m), 408(k), and 410(b)).

Congress intended that the Secretary will prescribe rules to effectuate the intent of the $200,000 limit on includible compensation. The purpose of the limitation is to ensure that reductions in the maximum contributions or benefits do not reduce the contributions or benefits of low- and middle-income employees. Congress concluded it would be inconsistent with this intent to permit plans to define compensation in such a manner that the $200,000 limit has little effect on highly compensated employees, while adversely affecting low- and middle-income employees.

In the case of a short plan year, the $200,000 is to be adjusted to reflect a limit for such short plan year. Thus, the $200,000 limit is to be prorated to determine a smaller limit for the short year.

Incorporation of provisions by reference

The Act provides that, notwithstanding any other provision of law and except as provided by Treasury regulations, a plan may incorporate by reference the overall limitations on contributions and benefits (sec. 415).

Under the Act, a plan does not fail to meet the requirements for qualified status merely because the plan incorporates the benefit and contribution limits of section 415 of the Code by reference. The Act provides that incorporation by reference is permitted except that, if the limitation may be applied in more than one manner, then the plan is to specify the manner in which the limitation is to be applied.

For example, in the case of a defined contribution plan, Treasury regulations provide several methods for establishing a suspense account for excess annual additions and for allocating amounts in the suspense account. Under the Act, a defined contribution plan that makes use of a suspense account is required to specify which method is to be used. Also, if an employee participates in both a defined contribution plan and a defined benefit pension plan maintained by the same employer, then the manner in which the employee's benefits will be adjusted to comply with the combined limitation (sec. 415(e)) is to be specified.

The Act continues the requirements of prior law relating to definitely determinable benefits. The Act also continues the requirement of prior law that a profit-sharing or stock bonus plan is to specify a definite allocation formula. Under the Act, however, a plan does not fail to provide definitely determinable benefits merely because it incorporates the limits of section 415 by reference.

Of course, as under prior law, the plan is required to limit the accrued benefit of any participant so that the limits are satisfied.

Effective Dates

In general

The provisions generally apply to years beginning after December 31, 1986. Under the Act, a plan will not fail to be qualified for any year beginning before January 1, 1989, merely because the plan is not amended to provide that benefits or contributions will not exceed the limits under the Act.

Employer deductions with respect to years beginning after December 31, 1986, are limited to those amounts required to fund benefits that do not exceed the limits provided by the Act (whether or not contributions required by the plan document exceed those limits). In addition, for years beginning after December 31, 1986, benefit accruals and benefit distributions are subject to the limits provided under the Act without regard to the plan document.

Collectively bargained plans

The Act provides a special effective date for plans maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, with respect to employees covered pursuant to the agreement.

Transitional rules relating to current accrued benefits

In general.—The Act provides a transition rule to ensure that a participant's previously accrued benefit under a defined benefit pension plan is not reduced merely because the Act reduces the dollar limits on benefits payable under the plan or increases the period of participation required to earn the maximum benefit. The transition rule applies with respect to an individual who is a participant as of the first day of the first year to which the amendments made by the Act apply if (1) the plan was in existence on May 6, 1986, and if the plan met the requirements of section 415 for all plan years to which the provision applies. Under the Act, if the transition rule applies to an individual whose current accrued benefit under the plan exceeds the limit otherwise determined under section 415 (as amended by the Act), then the applicable dollar limit (sec. 415(b)(1)(A)) for the individual is equal to that current accrued benefit. Similarly, in computing the participant's defined benefit plan fraction (sec. 415(e)), the current accrued benefit replaces the dollar limit otherwise used in the denominator of the fraction.

Computation of current accrued benefit.—Under the Act, an individual's current accrued benefit is defined as the individual's accrued benefit as of the close of the last year to which the new rules do not apply, expressed as an annual benefit determined pursuant to the rules in effect prior to the amendments made by the Act.

For purposes of determining an individual's current accrued benefit, no change in the terms and conditions of the plan after May 5, 1986, is to be taken into account. Accordingly, if an individual's current accrued benefit is a specified percentage of average pay, rather than a specified amount, the current accrued benefit is the specified percentage of the average pay computed as of the close of the last year to which the new rules do not apply, based upon compensation paid up to that time (without regard to compensation advances). Although subsequent salary increases might increase the benefit to which a participant is entitled under the plan, those salary increases do not increase the participant's current accrued benefit for purposes of this transition rule.

Similarly, cost-of-living adjustments occurring after May 5, 1986, are not to be taken into account in computing the current accrued benefit. In addition, with respect to an individual whose annual benefit is treated as not exceeding the annual benefit limit (sec. 415(b)) on account of the transitional rule provided by section 2004(d)(2) of the Employee Retirement Income Security Act of 1974, or section 237(g) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the individual's accrued benefit is the current accrued benefit as defined therein.

Benefits accruing in years to which the new rules apply are not protected by this transition rule. Thus, no further accruals will be permitted for an individual whose current accrued benefit exceeds the Act's usual dollar limit until that dollar limit, as adjusted for cost-of-living increases, exceeds the individual's current accrued benefit.

Under the Act, if a change is made in the terms or conditions of a plan pursuant to a collective bargaining agreement that is ratified before May 6, 1986, then the change is to be treated as a change made before May 6, 1986.

Computation of combined limit.—The Act provides that, in the case of a plan that satisfied the requirements of the overall limits on contributions and benefits (sec. 415) for its last year beginning before January 1, 1987, Treasury regulations are to provide for the determination of an amount that is to be subtracted from the numerator of the defined contribution fraction so that the sum of the defined benefit plan fraction and the defined contribution fraction (sec. 415(e)(1)) does not exceed 1.0 for such year determined as if the new rules were in effect in such year.[7] The amount is not to exceed the numerator of the fraction.

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[7] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H.Con. Res. 395 which passed the House and Senate in the 99th Congress.

Employee contributions treated as annual additions

Subject to the collective bargaining exception, the provision treating all employee contributions as annual additions generally is effective for years beginning after December 31, 1986. However, for purposes of applying the combined plan limit (sec. 415(e)), the prior-law rules will still apply in calculating the defined contribution plan fraction applicable to years beginning before January 1, 1987.

Includible compensation

The $200,000 limit on compensation taken into account is effective with respect to benefits accruing in years beginning after December 31, 1988. With respect to benefits accruing in years beginning after December 31, 1988, compensation in excess of $200,000 for any year, including years prior to 1989, is to be disregarded. A special effective date is provided in the case of a plan maintained pursuant to a collective bargaining agreement.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $315 million in 1987, $869 million in 1988, $960 million in 1989, $1,097 million in 1990, and $1,259 million in 1991.

2. Adjustments to section 404 limitations (sec. 1131 of the Act and secs. 404 and 4972 of the Code)[8]

Prior Law

In general

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. However, no deduction is allowed with respect to contributions or benefits in excess of the overall limits on contributions or benefits (sec. 404(j)).

Profit-sharing and stock bonus plans

In the case of a qualified profit-sharing or stock bonus plan, employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid (sec. 404(a)(3)). If employer contributions for a group of employees for a particular year exceed the deduction limits, then the excess may be carried over and deducted in later years (within limits).

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[8] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1131; H.Rep. 99-426, pp. 750-755; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1231; S.Rep. 99-313, pp. 631-635; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 479-482 (Conference Report).

Under prior law, if the contribution for a particular year was less than the maximum amount for which a deduction is allowed, then the unused limitation (i.e., the limit carryforward) could be carried over and used in later years. In the case of this limit carryforward, the total amount that could be deducted in a later year could not exceed 25 percent of the aggregate compensation of employees covered by the plan during that year.

Defined benefit pension plans

In general

Employer contributions under a defined benefit pension plan are required to meet a minimum funding standard (sec. 412). The deduction allowed for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.[9]

(2) The level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan (adjusted, if applicable, by a 10-year amortization of experience gains or losses) over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any 3 individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of those employees is spread over at least 5 taxable years.

(3) An amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits plus experience gains or losses in equal annual payments over 10 years (sec. 404(a)(1)).

Minimum funding

Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. Each funding method allocates total costs between the "normal cost" which is generally required to be funded currently and "past service costs" which are spread over a period of years.

Carryover of certain excess contributions

The minimum funding standard includes a provision (the full funding limitation) designed to eliminate the requirement that additional employer contributions be made for a period during which the plan is fully funded. The funding standard does not prohibit employers from making contributions in excess of the full funding limitation under prior and present law.

Employer contributions in excess of the deduction limits provided by the Code are not currently deductible. A deduction carryover is generally allowed, however, for employer contributions to a qualified plan in excess of the deductible limits.

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[9] Under the minimum funding standard, the normal cost of a plan for a year is required to be funded currently. Past service costs are required to be spread over a period of years. (The amortization period depends on the origin of the past service cost and on the funding method used by the plan.) Because the deduction limit is not less than the contribution required by the minimum funding standard, an employer is generally not required by that standard to make a nondeductible contribution. Contributions may be reduced or eliminated under a plan that has reached the full funding limitation.

Money purchase pension plans

Employer contributions to a money purchase pension plan are generally deductible to the extent required by the minimum funding standard. Under a qualified money purchase pension plan, the amount required under the minimum funding standard is the contribution rate specified by the plan.

Combination of pension and other plans

If an employer maintains a pension plan (defined benefit pension or money purchase) and either a profit-sharing or a stock bonus plan for the same employee for the same year, then the employer's deduction for contributions for that year is generally limited to the greater of (1) 25 percent of the aggregate compensation of employees covered by the plans for the year, or (2) the contribution necessary to meet the minimum funding requirements of the pension plan for the year.

Under prior law, the limit applied if an employer maintained both a defined benefit or money purchase pension plan and a profit-sharing or stock bonus plan for the same employee for a year. The limit did not apply, however, if the employer maintained both a defined benefit pension plan and a money purchase pension plan for the same employee for the same year because both plans were pension plans.

Reasons for Change

With respect to the 15-percent limit on annual contributions to a profit-sharing or stock bonus plan, Congress did not believe it was necessary or appropriate to provide limit carryforwards.

In addition, Congress was aware that larger deductions for plan contributions were available to an employer that maintained a defined benefit pension plan and a money purchase pension plan than would be allowable if the employer maintained a defined benefit pension plan and a profit-sharing or stock bonus plan. Because a money purchase pension plan is a defined contribution plan under which an employee accumulates benefits in an individual account in much the same manner as in a profit-sharing or stock bonus plan, Congress believed that a combination of a money purchase pension plan and a defined benefit pension plan should be subject to the same overall deduction limit as a combination of defined benefit pension plan and a profit-sharing or stock bonus plan.

Explanation of Provisions

Overview

The Act made several changes to the limits on employer deductions for contributions to qualified plans. The Act (1) repealed the limit carryforward applicable to profit-sharing and stock bonus plans, and (2) extended the combined plan deduction limit to include any combination of a defined benefit pension plan and a money purchase pension plan. In addition, the Act imposed a 10-

percent excise tax on nondeductible excess employer contributions to qualified plans.

Elimination of limit carryforward

In general

Under the Act, as under prior law, the contribution of an employer to a qualified profit-sharing or stock bonus plan is generally deductible in the taxable year for which it is paid. The employer's deduction for such a contribution generally may not exceed 15 percent of the compensation otherwise paid or accrued during the taxable year to employees who benefit under the plan.

However, the Act generally repeals limit carryforwards for a profit-sharing or stock bonus plan. Accordingly, if an employer's contribution for a particular year is less than the maximum amount for which a deduction may be allowed, the unused limit may not be carried forward to subsequent years.

Pre-1987 limitation carryforwards

The Act does not eliminate limitation carryforwards accumulated in the past. Under the Act, the deduction limit for any taxable year beginning after December 31, 1986, may be increased by the unused pre-1987 limitation carryforwards (but not to an amount in excess of 25 percent of compensation otherwise paid or accrued in that year to employees who benefit under the plan).

The Act defines the unused pre-1987 limitation carryforward applicable to any taxable year as the amount by which the 15-percent limit applicable to a profit-sharing or stock bonus plan (as in effect on the day before the date of enactment of the provision) for any taxable year beginning before January 1, 1987, exceeded the amount paid to the trust for that taxable year (to the extent the excess was not taken into account in any taxable year prior to the year for which the carryforward limit is being calculated).

Combinations of pension and other plans

The Act applies the combined plan limit to any combination of defined benefit pension and defined contribution plans if any employee benefits under both plans (sec. 404(a)(7)).

Under the Act, if an employer contributes to 1 or more qualified defined contribution plans (1 or more qualified money purchase pension plans, profit-sharing plans, or stock bonus plans) and 1 or more qualified defined benefit pension plans for a taxable year, then the amount deductible in that taxable year is not to exceed the greater of (1) 25 percent of the compensation otherwise paid or accrued during the taxable year to the employees who benefit under the plans, or (2) the amount of contributions made to or under the defined benefit pension plan to the extent necessary to meet the minimum funding standard for that plan (sec. 412). A fully insured plan (sec. 412(i)) is treated as a defined benefit pension plan for purposes of this limit. The Act further provides that the annual premium payments made by an employer under a fully insured plan are deemed to be the amount required to meet requirements of the minimum funding standard for the plan.

As under prior law, the otherwise applicable limits with respect to qualified pension, profit-sharing, and stock bonus plans (sec. 404(a)(1), (2) and (3)) are not reduced by the overall limit on deductions if no employee benefits under both a defined benefit pension plan and a defined contribution plan.

Under the Act, a money purchase pension plan that amends the plan contribution formula to limit required contributions to those that are deductible will not be treated as failing to provide definitely determinable benefits.

Excise tax on nondeductible contributions to qualified plans

In general

Under the Act, a 10-percent nondeductible excise tax is imposed on nondeductible contributions to a qualified pension, profit-sharing, or stock bonus plan.

Nondeductible contribution defined

In general.—Under the Act, the contributions to a plan that are subject to the excise tax on nondeductible contributions are (1) the amounts contributed to a qualified employer plan by the employer for the taxable year in excess of the amount allowable as a deduction for the taxable year, plus (2) the unapplied amounts in the preceding taxable year. The unapplied amounts in the preceding taxable year are the amounts subject to the excise tax in the preceding year reduced by the sum of (1) the portion of the amounts that are returned to the employer during the taxable year, and (2) the portion of such unapplied amounts that are deductible during the current taxable year. The Act does not modify the rules of the Code or ERISA under which an employer may be allowed to withdraw certain amounts held by a pension, profit-sharing, or stock bonus plan.

For example, assume that an employer made a nondeductible contribution of $100,000 for its 1988 taxable year. Assume further that, for its 1989 taxable year, the employer's contribution was $75,000 and the deductible limit was $150,000. Assume that no amount is returned to the employer and that the employer's contribution for 1990 is equal to the deductible limit for that year. Under the Act, the excise tax would apply to the nondeductible contributions of $100,000 for the 1988 taxable year and to the nondeductible contributions of $25,000 for the 1989 and 1990 taxable years.

The unapplied amounts in the preceding taxable year do not include nondeductible contributions made in years prior to the effective date of the excise tax on nondeductible contributions. However, in determining whether contributions after the effective date are subject to the excise tax, carryforwards from pre-effective date years are applied first against the deduction limit.

The term "nondeductible contributions" includes, for purposes of the excise tax, contributions allocable to the purchase of life, accident, health, or other insurance on behalf of a self-employed individual, but only to the extent that the contributions would be nondeductible without regard to the special rule limiting deductions for such contributions (sec. 404(e)).[10]

Time for determination.—Under the Act, nondeductible contributions for a year are determined as of the close of the employer's taxable year. A contribution made on account of a year that is made after the close of the year is to be taken into account in determining the level of excess contributions for the year with respect to which the contribution is made.

Because the determination of nondeductible contributions is made as of the end of the taxable year, contributions that are returned to the employer (to the extent permitted under sec. 401(a)(2)) by the due date of plan contributions for the year (sec. 404(a)(6)) are not treated as nondeductible contributions subject to the excise tax.[11]

Deduction subsequently disallowed.—If all or a part of the employer contributions with respect to a particular year are subsequently determined to be nondeductible, then, under the general rule, the employer contributions made for the year in excess of the amount determined to be deductible for that year are generally to be treated as nondeductible contributions that are subject to the 10-percent excise tax. Under the Act, the excise tax on nondeductible contributions applies in addition to any penalties or other taxes that may be appropriate (for example, the penalty on overstatement of deductions for pension liabilities). The 10-percent excise tax on nondeductible contributions does not apply, however, to an amount that, but for the fact that it is taken into account as a capital expense within the meaning of section 451, would otherwise be deductible as a contribution to a qualified plan.

Application of excise tax to underfunded plans.—In general, the excise tax on nondeductible contributions does not apply in the case of a plan that is underfunded.[12] A plan is underfunded if, as of the close of the plan year in which the taxable year begins, (1) the liabilities of the plan (determined as if the plan were terminated on that date) exceed (2) the assets of the plan. In the case of such an underfunded plan, contributions for a plan year up to the excess calculated under the preceding sentence are not subject to the excise tax even if such contributions are nondeductible.

Tax imposed on employer.—The excise tax on nondeductible contributions is imposed on the employer. Under the Act, in the case of a plan that provides contributions or benefits for employees some or all of whom are self-employed individuals (sec. 401(c)(1)), an individual who owns the entire interest in an unincorporated trade or business is treated as the employer. Also, under the Act, a partnership is to be treated as the employer of each partner who is considered to be an employee (sec. 401(c)(1)).

Under the Act, the excise tax on nondeductible contributions does not apply in the case of an employer that has been exempt from income tax at all times.[13] Under rules to be prescribed by the

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[10] A technical correction may be needed so that the statute reflects this intent.

[11] A technical correction may be needed so that the statute reflects this intent.

[12] A technical correction may be needed so that the statute reflects this intent.

[13] A technical correction may be needed so that the statute reflects this intent.

Secretary, this exception does not apply to the extent that the employer has been subject to unrelated business income tax or has otherwise derived a tax benefit from the qualified plan.

Particular problems may be presented in determining liability for the excise tax in the case of a multiemployer or multiple employer plan. Under present and prior law, deductions for contributions to such plans are determined by aggregating all employers contributing to the plan and treating them as a single employer (sec. 413(b)(7) and (c)(6)). It is anticipated that the Secretary will develop rules for allocating the liability for the excise tax in such cases.

Compensation taken into account

The Act imposes a limit on the amount of any employee's compensation that may be taken into account in computing the deduction allowed for an employer contribution to a qualified plan for a year (sec. 404(l)). Under the Act, no more than $200,000 of any employee's compensation for a year may be taken into account in computing deductions for plan contributions. The $200,000 limit is to be prorated for short years (see the discussion in 1., above). The limit is to be adjusted, beginning in 1990, for post-1988 cost-of-living increases at the time and in the manner provided for the adjustment of the overall limits on annual benefits under a qualified defined benefit pension plan (sec. 415(d)).

Increases in the $200,000 compensation may not be taken into account before they occur in determining the deduction limit for plan contributions.[14]

The $200,000 cap does not apply in the case of an employer's deduction for benefits provided under a nonqualified deferred compensation plan.

Effective Dates

In general

The provisions relating to deduction limits apply to employer taxable years beginning after December 31, 1986. However, certain unused pre-1987 limit carryforwards are not affected by the provision generally repealing limit carryforwards.

Excise tax on nondeductible contributions

The provisions relating to the excise tax on nondeductible contributions apply to taxable years beginning after December 31, 1986. Under the Act, however, amounts contributed for taxable years beginning before January 1, 1987, are not treated as excess contributions for a year beginning after December 31, 1986.[15] Under this exception, nondeductible contributions carried forward from years prior to 1987 are considered to be the first contributions taken into account for purposes of the deduction limits. Thus, employer contributions for years beginning after December 31, 1986, are considered to be deductible only to the extent of the excess of the deductible limit for the year over nondeductible carryforwards from pre-1987 years.

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[14] A technical correction may be needed so that the statute reflects this intent.

[15] A technical correction may be needed so that the statute reflects this intent.

For example, assume that an employer has a calendar year taxable year. For 1986, the employer's deduction limit is $100,000 and the employer contributes $300,000. In 1987, the employer again has a $100,000 deduction limit, but contributes nothing. Because the employer made no contribution after the effective date, there is no nondeductible contribution in 1987. In 1988, however, the deduction limit is again $100,000 and the employer contributes $75,000. In 1988, the employer has made a nondeductible contribution of $75,000 because the extra $200,000 contributed in 1986 is treated like a contribution for the year (through the year in which the contribution becomes deductible) for purposes of measuring the tax applicable to contributions for post-effective date years.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement.[16]

Compensation taken into account

The provision imposing a $200,000 limit on compensation taken into account in computing deductions applies to benefits accruing in years beginning after December 31, 1988.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $17 million in 1987, $42 million in 1988, $45 million in 1989, $49 million in 1990, and $54 million in 1991.

3. Excise tax on reversion of qualified plan assets to employer (sec. 1132 of the act and sec. 4980 of the Code)[17]

Prior Law

Under prior and present law, a qualified plan is required to be maintained for the exclusive benefit of employees (sec. 401(a)). Generally, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, the assets held under a qualified plan may not be used for, or diverted to, purposes other than the exclusive benefit of employees (sec. 401(a)(2)). However, if assets remain in a defined benefit pension plan upon plan termination as a result of actuarial error, then after the plan has satisfied all liabilities, those assets may be paid, as a reversion, to the employer.[18]

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[16] A technical correction may be needed so that the statute reflects this intent.

[17] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1132; H. Rep. 99-426, pp. 756-7; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1232; S. Rep. 99-313, pp. 635-8; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 482-4 (Conference Report).

[18] Under prior and present law, guidelines developed jointly by the Department of the Treasury, the Department of Labor, and the PBGC (the "implementation guidelines") set forth rules governing certain terminations of qualified defined benefit pension plans involving reversions of excess assets. In addition, prior and present law provides that certain contributions may be returned to employers if (1) the contribution is made by mistake of fact; (2) the contribution is conditioned on initial plan qualification and the plan does not qualify; or (3) the contribution is conditioned on its deductibility and the deduction is disallowed. See Rev. Rul. 77-200, 1977-1 C.B. 98.

Reasons for Change

Congress believed that it was appropriate to limit the tax incentives available for retirement savings provided through defined benefit pension plans to the amount actually applied to provide retirement income. To the extent that amounts in such plans are not used for retirement purposes and revert to an employer, Congress believed that the tax treatment of reversions should recognize that the tax on earnings on pension funds is deferred and, thus, the benefits of this tax treatment should be recaptured. Although Congress believed that it might be possible to determine the particular year or years in which contributions resulting in a reversion arose and to recoup the resulting tax benefit attributable to a reversion on that basis, Congress was concerned that such a computation would involve undue complexity. Under the circumstances, therefore, Congress determined that a nondeductible excise tax should be imposed on reversions at a uniform rate.

Congress believed, however, that it was appropriate to provide an exception to this tax in the case of certain transfers of excess assets to an esop (to the extent that such assets are invested in employer securities) in order to encourage greater establishment of such plans to promote employee stock ownership.

Explanation of Provisions

In general

The Act imposes a 10-percent nondeductible excise tax on a reversion from a qualified plan. The tax is imposed on the employer maintaining the plan. In the case of a self-employed individual or a partnership that is treated as the employer maintaining the plan under section 401(a), the self-employed individual or the partners are liable for the tax.

Under the Act, the excise tax applies to a reversion from a plan (or from a trust under a plan) if the plan met the requirements of the Code for qualified status (sec. 401(a) or sec. 403(a)) at any time or if the plan was at any time determined by the Secretary to have met those requirements. Of course, if an employer did not ever request a determination as to the qualified status of a plan, the Secretary could independently make a determination whether the plan had been qualified at any time.

Amount of reversion

The Act defines a reversion as the amount of cash and the fair market value of other property received (directly or indirectly) from a qualified plan. No inference is to be drawn from the definition of a reversion in the Act as to the income tax consequences and the effect on a plan's qualified status of a transfer of assets from a qualified plan that has not been terminated to another qualified plan.

The Act provides that an employer reversion does not include a distribution to an employer (1) in the case of a multiemployer plan, by reason of mistakes of law or fact or the return of any withdrawal liability payment, (2) in the case of a plan other than a multiemployer plan, by reason of mistake of fact, or (3) in the case of any plan, by reason of the failure of the plan to qualify initially or the failure of employer contributions to be deductible.

The provision of a benefit or other obligation that causes the disqualification of a plan (or would cause the disqualification of the plan if it were otherwise qualified) is to be taken into account as a reversion if it is provided pursuant to the termination of the plan. For example, if benefits under a plan are increased to a level in excess of the overall limits on contributions and benefits, and if the increase is related to or in contemplation of the termination of the plan, then the value of the excess benefits is to be treated as a reversion.

Under the Act, a reversion includes any payment to an employer under a participating annuity contract purchased upon plan termination.

Exception for certain employers

Under the Act, the excise tax on reversions does not apply to a reversion to an employer that has been tax exempt at all times or to a reversion from a governmental plan (within the meaning of sec. 414(d)). The exception for plans maintained by tax-exempt employers does not apply to the extent that the employer has been subject to unrelated business income tax or has otherwise derived a tax benefit from the qualified plan.

Special rule for assets transferred to ESOPs

The Act provides an exception to the excise tax on reversions in the case of transfers of assets from a defined benefit pension plan to an employee stock ownership plan (ESOP) (within the meaning of secs. 4975 or 409).[19] The amount transferred is not includible in the income of the employer, nor is the amount transferred deductible by the employer as a plan contribution. No inference is to be drawn from this exception as to the circumstances in which asset transfers will or will not satisfy the exclusive benefit rule and any other applicable qualification requirements (e.g., sec. 414(l)).

Under the Act, the amount transferred to the ESOP is required to be used, within 90 days after the transfer, to acquire employer securities (as defined in sec. 409(l)) or used to repay a loan the proceeds of which were used to acquire employer securities. The Secretary is authorized to prescribe a longer period for the plan to acquire employer securities.

In addition, under the Act, the employer securities may be allocated under the plan to ESOP participants immediately, subject to the dollar limits on annual additions under section 415(c). Alternatively, as provided under the plan, the amount transferred may be held in a suspense account pending allocation (provided allocations are made no more slowly than ratably over a 7-year period) or may be used to repay an acquisition loan (as described in section 404(a)(9)). Such allocations, the establishment of a suspense account, or the repayment of a loan is to occur within 90 days after the transfer. In the year in which the transfer occurs, the amount allocated to participants' accounts in the ESOP is not to be less than the lesser of (1) the maximum amount that could be allocated without violating the requirements of section 415 or (2) 1/8 of the total amount transferred.[20] If the plan is terminated prior to such amounts being fully allocated to participants' accounts or used to repay a loan, the employer will be subject to the 10-percent excise tax on such reversion amounts that were not allocated or so used.

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[19] A technical correction may be needed so that the statute reflects this intent.

The employer securities acquired with the transferred assets are to be held under the plan until distributed to plan participants. An exception to this rule applies if a plan participant elects to diversify a portion of the participant's account balance and diversification cannot be satisfied out of the nontransferred assets.[21] Of course, an employer could sell employer securities acquired with transferred assets as long as the proceeds of the sale are reinvested in employer securities within a reasonable period of time (such as 90 days or such other period as the Secretary prescribes).

Dividends paid on employer securities held in a suspense account are to be either (a) applied to repay an acquisition loan, or (b) paid out currently to plan participants and beneficiaries proportionate to their account balances (attributable to such amounts) on the date such dividends are distributed.

The amounts held in the suspense account that are required to be allocated each year are to be allocated to participants' accounts before any other employer contributions are allocated. In other words, during the period that reversion amounts are held in a suspense account, the employer is not permitted to make additional contributions to the ESOP or any other plan to the extent that the contributions, when added to the amounts held in the suspense account which are required to be allocated each year, would exceed the overall limits on annual additions under a defined contribution plan if allocated to participants' accounts.

Amounts transferred to a suspense account that (due to the limitations on contributions and benefits under sec. 415) cannot be allocated to participants' accounts within 7 plan years (including the years in which such amounts were transferred to the plan) are required to revert to the employer and are subject to the 10-percent excise tax in the taxable year in which such reversion occurs.

The waiver of the excise tax is to apply only if at least 50 percent of the employees who are participants in the terminated defined benefit pension plan (as of the date the notice of intent to terminate is filed with the PBGC) are also eligible to participate in the ESOP to which the excess assets are transferred. For this purpose, an employer may disregard those participants in the terminated defined benefit pension plan who are not employed by the employer on the date of the first allocation of such reversion amounts under the ESOP. Consequently, in the case of a spin-off termination, the 50-percent requirement is satisfied if 50 percent of the active employees are covered by the ESOP. All employees participating in the ESOP as of the close of the plan year in which the employer receives a notice of sufficiency of assets from the pension benefit guaranty corporation with respect to the termination of the defined benefit pension plan are to be entitled to share in that year's allocation of the excess assets in the ESOP.

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[20] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H. Con. Res. 395 which passed the House and Senate in the 99th Congress.

[21] A technical correction may be needed so that the statute reflects this intent.

The Act permits the ESOP to be maintained by any member of a controlled group of corporations, including a corporation other than the corporation that maintained the terminated defined benefit pension plan as long as the 50-percent requirement is met with respect to the employees participating in the ESOP.

For those employees receiving allocations under the ESOP, Congress intended that the employer provide the employees with a written notice describing the source of the funds attributable to the allocations (i.e., that the amounts represent excess assets determined upon termination of a defined benefit pension plan).

Effective Date

The provision applies to a reversion received after December 31, 1985, other than a reversion attributable to a plan termination occurring on or before December 31, 1985. For purposes of this provision, a termination is considered to occur on the proposed date of termination.

In the case of the special exception for transfers to an ESOP, the provisions generally apply with respect to transfers occurring before January 1, 1989. In addition, the exception applies in the case of transfers after December 31, 1988, pursuant to a plan termination that occurs before January 1, 1989.

A delayed effective date exception to the excise tax is provided in the case of certain employers. In addition, a certain employer may elect to have the provision apply to a reversion after 1985 pursuant to a plan termination occurring before 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $305 million in 1987, $100 million in 1988, $80 million in 1989, $50 million in 1990, and $50 million in 1991.

4. Excise tax on excess distributions from qualified retirement plans (sec. 1133 of the Act and sec. 4981A of the Code)[22]

Prior Law

Under prior and present law, the annual additions on behalf of a participant under a defined contribution plan are limited to the lesser of (1) 25 percent of compensation for the year, or (2) $30,000. Beginning in 1988, the dollar limit was to be adjusted for post-1986 cost-of-living increases under prior law. Under prior law, annual additions included employee contributions and a portion of employee contributions.

In addition, the limit on the annual benefit payable from a defined benefit plan under prior and present law is the lesser of (1) 100 percent of average compensation or (2) $90,000. Beginning in

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[22] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1133; H.Rep. 99-426, pp. 737-749; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 466-479 (Conference Report).

1988, the dollar limit on benefits is to be adjusted for post-1986 cost-of-living increases.

Prior and present law also provide an aggregate limit applicable to employees who participate in more than 1 type of plan maintained by the same employer. If an employee participates in a defined contribution plan and a defined benefit pension plan maintained by the same employer, the fraction of the separate limit used for the employee by each plan is computed and the sum of the fractions is subject to an overall limit (sec. 415(e)). Under prior and present law, the sum of the fractions is limited to 1.0. Although the sum of the fractions is limited to 1.0, adjustments made to the denominators of the fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied to the dollar limits) or 1.4 (as applied to the percentage of compensation limits).

Reasons for Change

Congress questioned why the overall limits were applied separately with respect to each employer, why the limits did not take into account appreciation in defined contributions plans, and why retirement savings accumulated in IRAs were not taken into account. Congress concluded that the overall limits were adopted to limit the total amount that could be accumulated on behalf of a participant on a tax-favored basis. Thus, Congress believed that there was no need to permit a participant to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits. Accordingly, Congress found it appropriate to impose an excise tax on certain excess retirement distributions.

Explanation of Provisions

In general

Under the Act, a new excise tax is imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. To the extent that aggregate annual distributions paid to a participant from such tax-favored retirement arrangements are excess distributions, the Act generally imposes an excise tax equal to 15 percent of the excess. The excise tax will be reduced by the amount of tax imposed on the distribution by the 10-percent additional income tax on early distributions (sec. 72(t)), as added by the Act.

The prohibition on the reduction of accrued benefits (sec. 411(d)(6)) precludes any such reduction to avoid the excise tax.

Distributions subject to the tax

In applying the limit, aggregate annual distributions made with respect to an individual from all pension, profit-sharing, stock bonus, and annuity plans, individual retirement accounts and annuities (IRAs), and tax-sheltered annuities generally are taken into account, regardless of the form of the distribution or the number of recipients. Thus, for example, all distributions received during a year, whether paid under a life annuity, a term certain or any other benefit form (including an ad hoc distribution) generally will be aggregated in applying the tax. The operation of community property laws is disregarded in determining the amount of such aggregate annual distributions.[23]

Under the Act, however, certain amounts are excluded in determining such aggregate annual distributions. Excludable distributions include (1) amounts representing a return of an individual's after-tax contributions (but not earnings thereon) or other amounts that are treated as part of the individual's investment in the contract;[24] (2) amounts excluded from the recipient's income because they are rolled over into another plan or an IRA; and (3) amounts excluded from the participant's income because they are payable to a former spouse pursuant to a qualified domestic relations order (sec. 414(p)) and includible in the spouse's income. Of course, distributions payable to the former spouse are aggregated with any other retirement distributions payable to such spouse for purposes of determining whether the spouse has excess retirement distributions subject to the tax. Distributions paid to other alternate payees (e.g., minor children) are includible in applying the limit.

Distributions made with respect to a participant after the death of the participant are disregarded in applying this annual limit and are subject instead to an additional estate tax.

In the case of an annuity contract that is distributed to an individual and not included in the individual's income, the distribution of the contract is disregarded in applying this excise tax. Rather, payments made under or received for an annuity contract are treated as retirement distributions subject to the annual limit and the excise tax.[25]

Definition of excess distributions

Under the Act, excess distributions are defined as the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed the greater of (1) $150,000 or (2) $112,500 (indexed at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan).

Under this provision, the applicable dollar limit is not adjusted to reflect the age at which benefit payments commence. Thus, the limit is neither decreased to reflect early commencement of benefits nor increased to reflect deferred commencement.

Lump-sum distributions

A special higher ceiling applies for purposes of calculating the excess distribution for any calendar year in which an individual receives a lump-sum distribution that is taxed under the 5-year or 10-year averaging rules (or the grandfathered long-term capital gains provision). Thus, this special rule for lump-sum distributions applies if the individual elects (1) 5-year income averaging, (2) phased-out long-term capital gains treatment, (3) grandfathered long-term capital gains treatment, or (4) grandfathered 10-year income averaging.[26] The higher ceiling is 5 times the otherwise applicable ceiling for such calendar year.

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[23] A technical correction may be needed so that the statute reflects this intent.

[24] A technical correction may be needed so that the statute reflects this intent.

[25] A technical correction may be needed so that the statute reflects this intent.

Thus, for example, if, in 1989, an individual receives a $300,000 lump-sum distribution and elects to tax such amount under the 5-year averaging rules, the special higher ceiling applicable for calculating the individual's excess distribution for the year is $750,000, assuming an otherwise applicable ceiling for 1989 of $150,000. Accordingly, no part of this individual's lump-sum distribution taxed under the 5-year averaging rules would be treated as an excess distribution subject to the 15-percent excise tax.

Under the Act, if an individual receives other retirement distributions during a taxable year in addition to a lump-sum distribution eligible for the special higher ceiling, the other retirement distributions are separately subject to the general rules relating to excess distributions and, thus, are subject to the 15-percent excise tax only to the extent that the aggregate of such other retirement distributions during the taxable year exceeds the generally applicable annual limit.

Post-death distributions

The Act provides special rules to calculate the extent to which retirement distributions made with respect to an individual after the individual's death are excess distributions. In lieu of subjecting post-death distributions (including distributions of death benefits) to the annual tax on excess distributions, the Act adds an additional estate tax equal to 15 percent of the individual's excess retirement accumulation. After the estate tax is imposed, post-death distributions are disregarded entirely in applying this tax. Thus, beneficiaries who are receiving distributions with respect to an individual after the individual's death (other than certain former spouses receiving benefits pursuant to a qualified domestic relations order) are not required to aggregate those amounts with any other retirement distributions received on their own behalf.

The excess retirement accumulation is defined as the excess (if any) of the value of the decedent's interests in all qualified retirement plans, annuity plans, tax-sheltered annuities, and IRAs, over the present value of annual payments equal to the annual ceiling ($150,000 or the applicable dollar limit in effect on the date of death), over a period equal to the life expectancy of the individual immediately before death. Such excess retirement accumulation is determined without regard to community property laws.[27]

In calculating the amount of the excess retirement accumulation, the value of the decedent's interest in all qualified plans, tax-sheltered annuities, and IRAs will be taken into account regardless of the number of beneficiaries. However, the amount of excess retirement accumulations does not include the value of any death benefits payable immediately after death with respect to a decedent to the extent that the sum of such death benefits plus other benefits payable with respect to the decedent exceeds the total value of benefits payable with respect to the decedent immediately prior to death.[28] Also, benefits that represent the decedent's investment in the contract or amounts payable to an alternate payee and includible in the alternate payee's income are also disregarded in determining the excess retirement accumulation. In addition, the decedent's interests are to be valued as of the date of death or, in the case of a decedent for whose estate an alternate valuation date had been elected, such alternate valuation date (sec. 2032).

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[26] A technical correction may be needed so that the statute reflects this intent.

[27] A technical correction may be needed so that the statute reflects this intent.

The Act also provides that, with respect to the special provision relating to the estate tax, the tax may not be offset by any credits against the estate tax (such as the unified credit).[29] In addition, Congress intends that, in calculating the excess retirement accumulation, individuals are required to use reasonable interest rates in accordance with rules prescribed by the Secretary. The Secretary may, by regulations, prescribe a range of interest rates and other permissible assumptions for purposes of applying the excise tax.

For purposes of the rules relating to income in respect of a decedent (sec. 691), the amount of the excise tax on excess distributions with respect to a decedent is treated as an estate tax paid.

Grandfather rule

Under the Act, certain individuals may elect to be covered by a special grandfather rule which exempts from the tax benefits accrued as of August 1, 1986 (including benefits accrued under any arrangements distributions from which are subject to the tax). Under the grandfather, in the case of a defined contribution plan or IRA, the accrued benefit as of August 1, 1986, is the participant's account balance on that date. In the case of a defined benefit plan, the accrued benefit as of August 1, 1986, is the present value of the participant's benefit under the plan, determined as if the participant separated from service on that date. For purposes of the grandfather rule, benefits accrued as of August 1, 1986, do not include amounts that, as of August 1, 1986, would not be distributions subject to the excise tax if distributed on that date.[30] Thus, amounts that represent an individual's investment in the contract or amounts payable to an alternate payee and includible in the alternate payee's income are disregarded in determining an individual's grandfathered accrued benefit. However, benefits accrued as of August 1, 1986, to which the participant does not have a nonforfeitable right are included in the definition of accrued benefits for purposes of the grandfather rule.

The grandfather rule is available if the individual receives retirement distributions subject to (1) the general rule, (2) the special rule for lump-sum distributions, or (3) the special estate tax.[31] If the grandfather treatment is elected, then, for all purposes, the annual limit is $112,500 (indexed), rather than the greater of $150,000 or $112,500 (indexed). For example, the estate tax would be imposed on the excess of the value of the decedent's interests in all tax-favored retirement arrangements over the present value of annual payments equal to $112,500 (indexed) over the decedent's life expectancy immediately before death. That excess would, however, be reduced by the excess of the grandfathered accrued benefit (as reduced due to lifetime distributions) over the present value described above.

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[28] A technical correction may be needed so that the statute reflects this intent.
[29] A technical correction may be needed so that the statute reflects this intent.
[30] A technical correction may be needed so that the statute reflects this intent.
[31] A technical correction may be needed so that the statute reflects this intent.

With respect to distributions prior to the death of the individual, the grandfathered amounts are treated as if received on a pro-rata basis and are taken into account in determining whether the $112,500 limit (as indexed) is exceeded. Under the pro-rata rule, the portion of a distribution not subject to the excise tax is determined by multiplying the distribution by a fraction the numerator of which is the grandfathered amount, and the denominator of which is the accrued benefit on the date of the distribution under all plans or programs subject to the tax. The portion determined to be exempt from the excise tax under this pro-rata rule reduces the remaining grandfathered accrued benefit. Distributions after August 1, 1986, and before the effective date reduce the grandfathered amount in the same manner.

For example, assume that, at the time of a distribution of $250,000, an individual's grandfathered benefit is equal to 80 percent of the individual's accrued benefit on such date under all plans or programs subject to the tax. Under the grandfather, $200,000 (80 percent of $250,000) is exempt from the tax. The remaining $50,000 is subject to the tax because the grandfathered amounts are taken into account in determining whether the distribution exceeds the $112,500 limit (as indexed).

The Secretary also has the authority to provide for an alternative grandfather rule for such individuals. Congress intends that the Secretary consider providing an alternative grandfather rule based on a fraction the numerator of which is the months of service between age 35 and August 1, 1986, and the denominator of which is total months of service after age 35. This rule applies as long as grandfathered amounts are taken into account in applying the excise tax to nongrandfathered amounts (as under the general grandfather rule).

The election to use the grandfather rule is to be made on a return for a year beginning no later than January 1, 1988, and is to be in such form and contain such information as the Secretary may prescribe.

The election, once made, applies generally to all retirement distributions made with respect to an individual, including amounts subject to the special estate-level tax after the individual's death. In addition, if an individual dies before the end of the election period, the executor of the individual's estate could make the grandfather election.

Effective Dates

The provisions generally apply to distributions made after December 31, 1986. The special tax applied to the estate of a decedent is effective with respect to estates of decedents dying after December 31, 1986.

The provisions do not apply to distributions before January 1, 1988, that are made on account of the termination of a qualified plan if the termination occurred before January 1, 1987.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

E. Miscellaneous Pension and Deferred Compensation Provisions

1. Discretionary contribution plans (sec. 1136 of the Act and secs. 401(a)(27), 404, and 818 of the Code) [1]

Prior Law

Under prior and present law, the level of employer contributions to a profit-sharing or stock bonus plan may vary from year to year at the discretion of the employer. Under prior law, an employer's discretion with respect to the level of contributions to a profit-sharing plan was limited by the requirement that the employer's contribution to the plan in any given year could not exceed the employer's current or accumulated profits. It was unclear under prior law whether a tax-exempt employer was entitled to maintain a profit-sharing plan because a tax-exempt employer generally does not have profits in the ordinary sense.

Reasons for Change

Congress believed that the prior-law requirements that contributions to a profit-sharing plan be made out of current or accumulated profits had no policy justification, and could, in some instances, needlessly prevent employers from making contributions to a plan. Further, Congress saw no justification for precluding tax-exempt employers from maintaining discretionary contribution plans.

Explanation of Provision

Under the Act, employer contributions to a profit-sharing plan are not limited to the employer's current or accumulated profits. This provision applies without regard to whether the employer is a tax-exempt organization. Congress also intended that the Secretary may require defined contribution plans to contain provisions specifying whether they are pension plans or discretionary contribution plans. In addition, if in a year an employer does not make a contribution to a defined contribution plan, or only makes a nominal contribution, the existence of profits continues to be a factor to be considered in determining whether there has been a complete discontinuance of contributions under the plan or merely a temporary cessation of contributions.

Effective Date

The provision was effective for plan years beginning after December 31, 1985.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1111; H.Rep. 99-426, pp. 685-694; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1235; S.Rep. 99-313, p. 639; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 485 (Conference Report).

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

2. Requirement that collective bargaining agreements be bona fide (sec. 1137 of the Act and sec. 7701(a)(46) of the Code)[2]

Prior Law

Under prior and present law, many of the nondiscrimination provisions applicable to qualified plans and employee benefits provide special rules for (or do not apply to) plans or programs maintained pursuant to an agreement that is found to be a collective bargaining agreement if there is evidence that the relevant benefits were the subject of good faith bargaining between the employer and employee representatives. In addition, effective dates for amendments to the Code are often delayed with respect to plans or programs maintained pursuant to a collective bargaining agreement. Prior law provided no clear definition of a collective bargaining agreement, but did limit the scope of the term "employee representatives" (sec. 7701(a)(46)).

Reasons for Change

Congress was aware that some promoters of tax avoidance arrangements had entered into arrangements with employers under which, superficially, the employer and its employees were represented by agents in collective bargaining. Under the arrangement, however, no good faith bargaining occurred because the bargaining agent for the employees merely acted in concert with the named bargaining agent for the employer.

In some cases, the named bargaining agent for the employees had obtained a ruling by the Internal Revenue Service that the agent was exempt from income tax because it was a labor organization. Promoters of these arrangements had, on the basis of such a determination, represented to employers that the named agent had been determined to be an employee representative within the meaning of the provisions of the Code and ERISA. Of course, it is clear that a determination with respect to an organization's status for tax exemption is not a determination with respect to whether that organization, even if tax-exempt, is an employee representative.

Congress believed that these arrangements were, in fact, designed for no material purpose other than the improper manipulation of provisions that are appropriate only for legitimate collectively bargained plans. Congress intended to make clear that it does not regard such an arrangement as the product of good faith bargaining and that it does not consider an entity to be an employee representative merely because of its status for tax exemption or because of a determination by the Internal Revenue Service with respect to that status. Congress also intended that no inference should be drawn from this discussion with respect to the issue of whether such an organization can meet the requirements of the Code for tax-exempt status. In addition, Congress intended that no inference should be drawn from this discussion as to whether the promoters of these arrangements are subject to assessable penalties for the promotion of abusive tax shelters.

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[2] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1138; H.Rep. 99-426, pp. 759-760; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1236; S.Rep. 99-313, pp. 639-641; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 485-486 (Conference Report).

Explanation of Provision

The Act clarifies that no agreement will be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and one or more employers. An organization is not to be considered a bona fide employee representative merely because it is affiliated with an organization that is a bona fide employee representative with respect to certain collective bargaining agreements.

Effective Date

The provision is effective upon enactment. Because the provision is a clarification of prior law, Congress intended that this provision be given retroactive effect where appropriate.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

3. Treatment of certain fishermen as self-employed individuals (sec. 1143 of the Act and sec. 401(c) of the Code)[3]

Prior Law

Certain fishermen who otherwise would be treated as common-law employees under the usual rules for determining an employer-employee relationship are treated as self-employed individuals for purposes of employment taxes (secs. 3121(b)(20) and 3306(c)(20)).

The Internal Revenue Service has held that, although these individuals are treated as self-employed individuals for employment tax purposes, they are treated as employees for purposes of determining whether a pension, profit-sharing, or stock bonus plan maintained by the owner or operator of the boat (or boats) is a qualified plan under section 401(a).[4]

Reasons for Change

Congress recognized that the practical effect of the Internal Revenue Service's position with respect to the status of these fishing crew members under the qualified plan rules was to prevent an individual fishing crew member from establishing a Keogh plan. This meant that these individuals might not be receiving adequate pension coverage because the owner or operator of the boat might not maintain a qualified plan for all its employees. Therefore, Congress believed that the rules for members of certain fishing crews regarding eligibility to maintain a Keogh plan should be conformed to the treatment of such individuals for employment tax purposes.

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[3] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1237; S.Rep. 99-313, pp. 641-642; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 486-487 (Conference Report).

[4] Rev. Rul. 79-101, 1979-1 CB 156.

Explanation of Provision

Under the Act, members of certain fishing boat crews (described in sec. 3121(b)(20)) are treated as self-employed individuals for purposes of the rules relating to qualified plans.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

4. Cashout of certain accrued benefits (sec. 1139 of the Act, secs. 411 and 417 of the Code, and secs. 203 and 205 of the Employee Retirement Income Security Act of 1974) [5]

Prior Law

Under prior and present law, in the case of an employee who separates from service, a pension, profit-sharing, or stock bonus plan may not immediately distribute any portion of the participant's benefit without the participant's consent if the present value of the participant's accrued benefit exceeds $3,500 (sec. 411(a)(11) of the Code and sec. 203 of the Employee Retirement Income Security Act (ERISA)). The interest rate used in determining the present value of a benefit for purposes of these cashout rules may not exceed the interest rate that would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation (PBGC) for purposes of determining the present value of a lump-sum distribution upon termination of the plan. The PBGC rate in effect at the beginning of a plan year may be used throughout the plan year if the plan so provides.

Under prior and present law, with respect to those plans subject to the automatic survivor benefit requirements (Code secs. 401(a)(11) and 417 and ERISA sec. 205), if the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) is required to be obtained before the plan can immediately distribute any part of the present value in a form other than a qualified joint and survivor annuity or a qualified preretirement survivor annuity. The interest rate used for determining the present value of a benefit for this purpose may not exceed the interest rate that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of a lump-sum distribution on plan termination. The PBGC rate in effect at the beginning of a plan year may be used throughout the plan year if the plan so provides.

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[5] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1238; S.Rep. 99-313, pp. 642-643; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 487-489 (Conference Report).

Under prior law, temporary Treasury regulations provided that the interest rate assumptions described above applied not only for purposes of determining whether the present value of a benefit exceeded $3,500, but also for purposes of determining the amount to be distributed by the plan as the present value of a benefit.

Reasons for Change

Congress was concerned that the prior-law cashout rules encouraged plan participants with substantial benefits to request a cashout of benefits in order to receive a favorable interest rate assumption on the cashout. Therefore, Congress found it appropriate to increase the permissible interest rate with respect to cashouts of substantial benefits. Congress did not make the same change with respect to less substantial benefits in order to avoid reducing benefits for individuals with smaller retirement benefits. With respect to the cashout rules for the valuation of deferred benefits, Congress believed that the appropriate deferred interest rates rather than the immediate rate should be used.

Explanation of Provision

The Act amended the permissible interest rate to be used for purposes of determining the present value of (1) a participant's vested accrued benefit, (2) a qualified preretirement survivor annuity, or (3) a qualified joint and survivor annuity. Under the Act, a plan is required to use an interest rate no greater than the interest rate (deferred or immediate, whichever is appropriate) that would be used by the PBGC (as of the date of distribution) upon the plan's termination for purposes of determining whether (1) a participant's accrued benefit can be cashed out without consent because the present value of the vested accrued benefit is not greater than $3,500 and (2) the present value of a participant's vested accrued benefit is not greater than $25,000.[6]

If the present value of the vested accrued benefit is no more than $25,000, then the amount to be distributed to the participant or beneficiary is calculated using an interest rate no greater than the applicable PBGC rate. If, using the rate permitted by the previous sentence, the present value of the vested accrued benefit exceeds $25,000, then the Act provides that the amount to be distributed is determined using an interest rate no greater than 120 percent of the applicable PBGC rate. In no event, however, is the amount to be distributed reduced below $25,000 when the interest rate used exceeds the applicable PBGC rate.

For example, assume that, upon separation from service, the present value of an employee's total vested accrued benefit (including, e.g., any accrued benefits within section 411(d)(6) for which the employee is not yet eligible) is $50,000 using the applicable PBGC rate. Under the Act, the plan may distribute to this employee (if the employee and, if applicable, the employee's spouse consent) the total vested accrued benefit calculated using 120 percent of the applicable PBGC rate (e.g., $47,000).

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[6] The Technical Corrections title of the Act provided that the determination of whether a participant's accrued benefit may be cashed out without consent is to depend on the amount of the *vested* accrued benefit, rather than the amount of the total accrued benefit.

Congress recognized that the PBGC is considering adopting a new method and interest rate structure for valuing accrued benefits on plan termination. If a new method and structure are adopted, the Secretary is directed to provide timely guidance regarding the method of compliance with this provision of the Act.

As under prior law, the PBGC rate in effect at the beginning of the plan year may be used throughout the plan year if the plan so provides.

In addition, the Act provides that a reduction in accrued benefits is not to be treated as an impermissible cutback in accrued benefits (sec. 411(d)(6) of the Code and sec. 204(g) of ERISA) to the extent the reduction is attributable to the calculation of the present value of an accrued benefit in a manner permitted under the provision described above. This rule applies if the plan is amended to provide for such calculation before the close of the first plan year beginning on or after January 1, 1989.[7]

Effective Date

The provision is effective for distributions in plan years beginning after December 31, 1984, except that the provision does not apply to distributions in plan years beginning after December 31, 1984, and beginning before January 1, 1987, that were made in accordance with the temporary Treasury regulations issued under the Retirement Equity Act of 1984.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

5. Time required for plan amendments, issuance of regulations, and development of section 401(k) model plan (secs. 1140-1142 of the Act)[8]

Prior Law

If the qualification requirements of the tax laws are changed, prior and present law generally require that conforming plan amendments be adopted no later than the last day of the first plan year to which the change applies and the amendments are required to be effective, for all purposes, not later than the first day of that plan year.[9]

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[7] A technical correction may be needed so that the statute reflects this intent.

[8] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1137; H.Rep. 99-426, pp. 758-759; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1239-1241; S.Rep. 99-313, pp. 643-645; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 489-491 (Conference Report).

[9] Under Treasury regulations, plan provisions (or the absence thereof) that would cause disqualification due to ERISA or TEFRA (but not other Acts) generally are "disqualifying provisions" eligible for an extended period in which to amend the plan ("remedial amendment period").

Reasons for Change

Given the number of qualification changes made by the Act, Congress believed it appropriate to provide an extended remedial amendment period for required plan amendments. In the interim, the Internal Revenue Service is to provide a model amendment that allows employers to conform their plan in a simplified manner to changes that are required to be adopted operationally.

With respect to certain provisions, Congress believed that Treasury should issue final regulations by February 1, 1988, to provide guidance to taxpayers.

In order to make section 401(k) plans more widely available to employers, especially small employers, Congress believed that the Secretary should issue opinion letters with respect to master and prototype section 401(k) plans.

Explanation of Provision

Plan amendments

The provisions of the Act generally apply as of the separately stated effective date (generally, years beginning after December 31, 1986, or December 31, 1988). However, a plan will not fail to be a qualified plan on account of changes required to be made by the Act [10] for any plan year beginning before January 1, 1989, provided—

(1) the plan complies, in operation, with the required changes as of the separately stated effective date;

(2) the plan is amended to comply with the required changes no later than the last day of the first plan year beginning after December 31, 1988; and

(3) the amendment applies retroactively to the separately stated effective date.

During this period, a plan will not be disqualified merely because the plan is not operated in a manner that conforms to the plan document and, therefore, violates the requirements that (1) benefits be definitely determinable, (2) a plan's terms be set forth in a written document, or (3) the plan operate in accordance with its terms. Of course, plan modifications not required by the Act (e.g., benefit increases; allocation of forfeitures under a money purchase pension plan) are not within this special amendment rule and are to be made in accordance with the generally applicable rules.

Collectively bargained plans

A plan that is maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986, will not fail to be a qualified plan on account of changes required to be made by the Act for any plan year beginning before the later of (1) January 1, 1989, or (2) the earlier of (a) January 1, 1991, or (b) the date on which the last of the collective bargaining agreements pursuant to which the plan is maintained terminates (determined without regard to any extension of the terms of any agreement ratified after February 28, 1986), provided—

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[10] A technical correction may be needed so that the statute reflects this intent.

(1) the plan complies, in operation, with the required changes as of the separately stated effective date;

(2) the plan is amended to comply with the required changes no later than the last day of the first plan year beginning on or after the later of (a) January 1, 1989, or (b) the earlier of (i) January 1, 1991, or (ii) the date on which the last of the collective bargaining agreements pursuant to which the plan is maintained terminates (determined without regard to any extension of the terms of any agreement ratified after February 28, 1986);[11] and

(3) the amendment applies retroactively to the separately stated effective date.

During the period in which required plan amendments need not be made due to this provision, a plan will not be disqualified merely because it is not operated in a manner that conforms to the plan documents, as is the case with respect to noncollectively bargained plans. Also, plan modifications not required by the Act are not within this special amendment rule.

Congress also intended that any plan amendment made pursuant to a collective bargaining agreement relating to the plan that amends the plan solely to conform to a requirement added by the Act (see, generally, Titles XI and XVIII) is not to be treated as a termination of the agreement.[12] Of course, Congress did not intend to create an inference that such an amendment otherwise would be considered a termination, or that an amendment made solely to conform a plan to a requirement added by another Act is considered a termination.

Model amendment

Under the Act, the IRS is to issue a model amendment before December 21, 1986, that plans may adopt for plan years prior to the plan year in which amendments are required to be made by the provisions described above. Such model amendment is to address only those statutory provisions that are effective, with respect to noncollectively bargained plans, for any period prior to the first plan year beginning after December 31, 1988.

Issuance of regulations

The Act provides that by February 1, 1988, the Secretary is to issue final regulations with respect to the following provisions of the Act: (1) the rules relating to the integration of benefits; (2) the coverage requirements for qualified plans; (3) the minimum vesting standards; (4) the definitions of "highly compensated employees" and "compensation" (sec. 414(s)); (5) the rules regarding separate lines of business; (6) the amendments applicable to qualified cash or deferred arrangements (sec. 401(k) plans); (7) the new nondiscrimination rules for employer matching and employee contributions (sec. 401(m)); (8) the nondiscrimination rules for tax-sheltered annuities; and (9) the 15-percent tax on excess distributions.

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[11] A technical correction may be needed so that the statute reflects this intent.

[12] A technical correction may be needed so that the statute reflects this intent.

Master and prototype 401(k) plans

The Act provides that the Internal Revenue Service is required, not later than May 1, 1987, to begin accepting applications for opinion letters with respect to master and prototype plans for qualified cash or deferred arrangements.

Effective Date

These provisions are effective on the date of enactment.

Revenue Effect

These provisions are estimated to have no effect on budget receipts.

6. Penalty for overstatement of pension liabilities (sec. 1138 of the Act and new sec. 6659A of the Code) [13]

Prior Law

An employer is allowed a deduction for contributions (within limits) to a trust that is part of a qualified plan. Similar rules apply to plans funded with annuity contracts.

If the Internal Revenue Service determines that the actuarial assumptions used to calculate employer liabilities under a defined benefit plan are unreasonable, the limit on employer deductions is recalculated using reasonable assumptions and the excess deduction is disallowed.

Prior law did not provide a specific penalty for overstatements of employer liability under a defined benefit pension plan.

Reasons for Change

Congress was aware that, in some instances, deductions for employer contributions to defined benefit pension plans have been based on overstatements of the liabilities under the plans. For example, cases have been found in which the liability of a plan to provide benefits with respect to unmarried professionals, who were the sole owners and employees of their professional corporations, were overstated through the use of extreme actuarial assumptions. A pattern was found in which a corporation's deductions were based on the assumptions that (1) the professional employee will be married when benefits commence; (2) the spouse will be considerably younger than the employee (20 years in one case); (3) the spouse will outlive the employee; and (4) the plan will provide survivor benefits to the surviving spouse for an extended period. Congress also was aware of cases in which plans enjoying investment yield in excess of 9 percent were computing deductions on the basis of a 5-percent investment yield.

Congress did not believe that the present-law deduction sanction was effective. Even if excessive deductions are disallowed, certain deduction carryovers are permitted. Congress believed it necessary to provide a more effective deterrent to discourage overstatement of pension liabilities and, thus, found it appropriate to apply a specific penalty on such overstatements.

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[13] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1139; H.Rep. 99-426, pp. 760-764; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 491-493 (Conference Report).

Explanation of Provision

The Act provides a penalty on the taxpayer in the form of an addition to tax equal to a specified percentage of any income tax underpayment attributable to an overstatement of pension liabilities. As an addition to tax, this penalty is to be assessed, collected, and paid in the same manner as a tax.

The underpayment attributable to an overstatement of pension liabilities is the excess of the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation of deductions for pension liabilities and takes into account any other proper adjustments) over (2) actual tax liability as reduced by taking into account the overstatement of pension liabilities.

If there is an overstatement of pension liabilities, the following percentages are used to determine the applicable addition to tax:

If the valuation claimed is the following percent of the correct valuation—	*The applicable percentage is—*
Less than 150 percent	0
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

The overstatement penalty does not apply if the underpayment for a taxable year attributable to all such overstatements is less than $1,000. In addition, the Act grants the Secretary discretionary authority to waive all or part of the penalty on a showing by a taxpayer that there was a reasonable basis for the deduction claimed on the return and that the claim was made in good faith.

Congress intended that reliance on an enrolled actuary or on another professional by an employer with respect to the proper amount of the deduction will not constitute a reasonable basis or good faith claim by the employer.

Congress intended that the IRS will assess the penalty on account of either the use of unreasonable actuarial assumptions or the use of methods that accelerate deductions with respect to a plan. Congress recognized that the overstatement of liabilities has taken place primarily with respect to defined benefit pension plans of professional corporations covering a small number of employees and has involved the use of unreasonable actuarial assumptions regarding, for example, interest rates. In addition, the enrolled actuary in these cases has sometimes calculated plan funding requirements (and deductions) by either explicitly or implicitly (for example, through the use of high annuity purchase rates, based on low interest rates, at retirement) assuming cost-of-living increases in the dollar limitation of section 415 of the Code even though this is not permitted. Congress intended that such cases should be closely scrutinized. Of course, the Act did not override the rule of prior law under which an individual actuarial assumption is not required to be reasonable per se, as long as all actuarial assumptions are reasonable in the aggregate.

Effective Date

The provision applies to overstatements occurring after the date of enactment (October 22, 1986).

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

7. Retirement Equity Act of 1984 (REA) effective date (sec. 1145 of the Act, sec. 401(a)(11) of the Code, sec. 205 of the Employee Retirement Income Security Act of 1974, and sec. 303 of REA) [14]

Prior Law

Under the Retirement Equity Act of 1984 (REA), a pension plan is to provide automatic survivor benefits (1) in the case of a vested participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a qualified preretirement survivor annuity. The qualified joint and survivor annuity and qualified preretirement survivor annuity provisions apply to any participant who performs at least one hour of service under the plan on or after the date of enactment.

REA provided a special transition rule for participants who separated from service before the date of enactment and whose benefits were not in pay status as of the date of enactment. This provision applies if (1) a participant completed at least one hour of service under the plan after September 1, 1974, (2) the participant separated from service before the first day of the first plan year beginning on or after January 1, 1976, and (3) the plan is required to provide a qualified joint and survivor annuity. Under this special rule, the participant is to be provided the right to elect to receive benefits in the form of a qualified joint and survivor annuity.

Reasons for Change

Congress believed that in the case of a certain type of plan, imposition of the survivor benefit requirements of REA created too large an administrative burden in comparison to the benefits of such requirements.

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[14] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S8066 (June 20, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 493-494 (Conference Report).

Explanation of Provision

Under the Act, a plan is exempt from the survivor benefit requirements of REA if (1) the plan was established prior to January 1, 1954, as a result of an agreement between employee representatives and the Federal Government during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry, and (2) under the plan, participation is substantially limited to participants who, before January 1, 1976, ceased employment covered by the plan.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

8. Employee leasing (sec. 1146 of the Act and sec. 414(n) and (o) of the Code)[15]

Prior Law

For purposes of specified pension requirements, a leased employee is treated as the employee of the person for whom the leased employee performs services (the "recipient"). A leased employee is generally defined as any person who is not an employee of the recipient and who provides services to the recipient if 3 requirements are met. The first requirement is that such services be provided to the recipient under an agreement between the recipient and the organization providing the person's services (the "leasing organization"). Second, the person is required to have performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for at least 1 year. Third, such services are required to be of a type historically performed, in the business field of the recipient, by employees.

Generally, the pension requirements for which a leased employee is treated as an employee are the rules regarding nondiscrimination, vesting, limitations on benefits and contributions, top-heavy plans, and simplified employee pensions (SEPs).

A leased employee covered by a safe-harbor plan maintained by the leasing organization generally is not treated as an employee of the recipient. A safe-harbor plan is a money purchase pension plan that provides for immediate participation and for full and immediate vesting and that has a nonintegrated employer contribution rate of at least 7½ percent.

Reasons for Change

Congress was concerned that the provision rendering the employee leasing rules inapplicable to individuals covered by a safe-harbor plan was being used to avoid the nondiscrimination rules applicable to qualified plans. Instead of covering nonhighly compensated employees under a plan providing benefits comparable to those being provided to highly compensated employees, some employers arranged to lease their nonhighly compensated employees from leasing organizations maintaining safe-harbor plans. The effect of such an arrangement frequently was that the leased employees received significantly smaller qualified plan benefits than would have been required by the nondiscrimination rules had the leased employees been considered employees of the employer. Thus, Congress believed it appropriate to limit the availability of the safe-harbor plan rule to instances where only a small portion of an employer's workforce are leased employees. Moreover, Congress also modified the definition of a safe-harbor plan so that it would provide higher benefits and coverage to a broader group of the leasing organization's employees.

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[15] For legislative background of the provision, see: H.Rep. 99-841, Vol. II (September 18, 1986), pp. 494-497 (Conference Report).

Congress also recognized that the recordkeeping burden required for compliance with the employee leasing rules is not insubstantial. Congress therefore found it appropriate to reduce that burden in situations where the benefits of applying the employee leasing rules do not justify the burdens.

Also, Congress believed that the employee leasing rules should apply to the employee benefit exclusions, such as for health insurance. It is inappropriate for employee leasing to be used to avoid the rules regarding these exclusions, such as the applicable nondiscrimination rules.

Explanation of Provision

Overview

The Act makes several modifications to the employee leasing rules. Generally, the Act (1) modifies in 2 ways the definition of a safe-harbor plan, (2) limits the availability of the safe-harbor plan rule, (3) extends the employee leasing rules to certain employee benefit requirements, (4) modifies the service crediting rules, (5) clarifies the application of the rules aggregating commonly controlled employers, and (6) provides relief from the recordkeeping requirements attributable to the employee leasing provisions.

Modification of definition of safe-harbor plan

The Act modifies the definition of a safe-harbor plan in 2 ways. First, the Act raises the required contribution rate from 7½ percent to 10 percent.

Second, the Act requires that, to be a safe-harbor plan, a plan is required to cover all employees of the leasing organization (beginning with the date they become employees of the leasing organization) other than (1) employees whom the leasing organization demonstrates to the satisfaction of the Secretary performed substantially all of their services for the leasing organization (and not for recipients), and (2) employees whose total compensation from the leasing organization is less than $1,000 during the plan year and during each of the 3 prior plan years.

As under prior law, an employee covered under a safe-harbor plan is to receive the required allocation regardless of the number of hours of service credited to the employee for the year, regardless of whether the employee is employed by the leasing organization on any specified date during the year, and regardless of the employee's age.

In addition, the Act provides a definition of compensation for purposes of the 10-percent contribution rate and the $1,000 rule. For these purposes, compensation is to have the same meaning used for purposes of the limitation on benefits or contributions (sec. 415), except that there is to be added to such amount elective deferrals under a qualified cash or deferred arrangement, SEP, or tax-sheltered annuity program and elective contributions under a cafeteria plan.

Inapplicability of safe-harbor plan rule

The Act also provides that each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe-harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased employees (as specially defined below). The term "nonhighly compensated workforce" is defined to mean the number of persons (other than highly compensated employees) who are (1) employees of the recipient (other than leased employees (as specially defined below)) and have performed services for the recipient (or for the recipient and related persons) on a substantially full-time basis for a period of at least 1 year, and (2) leased employees (as specially defined below) with respect to the recipient. For purposes of this 20-percent rule, the term "leased employee" means (1) any person who would be a leased employee under the general rules (without regard to a safe-harbor plan), and (2) any person who during the plan year performs services for the recipient both as a nonemployee and as an employee, and who (without regard to a safe-harbor plan) would be a leased employee if all such services and services in prior years were performed as a nonemployee.

Application of employee leasing rules to employee benefits

The Act also applies the employee leasing rules for purposes of certain employee benefit requirements (see Part F.1., below) and modifies certain of the employee leasing rules accordingly. The exemption from the application of the employee leasing rules with respect to individuals covered by a safe-harbor plan is inapplicable to employee benefits. In addition, with respect to core health benefits, the period during which an individual is required to perform services on a substantially full-time basis is reduced from 1 year to 6 months.

Service credit rules

With respect to the employee leasing rules generally, the Act clarifies that in the case of an individual who is an employee of the recipient (whether by reason of being a leased employee or otherwise), for purposes of the applicable requirements, service includes any period of service during which the employee would have been a leased employee but for the requirement that substantially full-time services be performed for at least 1 year (6 months in the case of core health benefits). Of course, service as an employee (whether by reason of being a leased employee or otherwise) is also credited.

Aggregation of employers

The Act also clarifies that the rules aggregating certain employers (sec. 414(b), (c), (m), and (o)) apply for purposes of the employee leasing rules. Thus, for example, the term "recipient" includes, in addition to the employer or employers for which the services are performed, other aggregated employers.

Recordkeeping relief

The Act requires that regulations be issued to minimize the recordkeeping requirements attributable to the employee leasing provisions in the case of an employer that has no top-heavy plans (sec. 416) and that uses the services of nonemployees only for an insignificant percentage of the employer's total workload.

Congress intended that this recordkeeping rule apply to employers with respect to which the number of individuals performing substantial services as nonemployees is less than 5 percent of the number of nonhighly compensated employees performing substantial services.

Further, Congress intended that the Secretary is to prescribe objective rules to determine if an individual has performed substantial services. Under such rules, an individual is to be treated as having performed substantial services as a nonemployee only if such individual has at least 1,500 hours of service. Also, in lieu of requiring that the number of nonhighly compensated employees performing substantial services be determined, the Secretary may generally deem the number of nonhighly compensated employees performing substantial services to be equal to the number of nonhighly compensated employees covered by a qualified plan of the employer (other than those considered to perform substantial services as a nonemployee). (For an employer that does not maintain a qualified plan, the Secretary may allow use of the number of participants in, for example, a health plan.) In addition, with respect to individuals performing services both as an employee and as a nonemployee, services in both capacities generally are to be taken into account and, for purposes of determining if an individual has performed substantial services as a nonemployee or as an employee, counted as service as a nonemployee.

Congress further intended that the Secretary is to prescribe appropriate rules to minimize the recordkeeping necessary to determine if this 5-percent test has been satisfied. Thus, for purposes of determining whether a nonemployee has performed substantial services, the Secretary may permit an employer not to check whether an individual who performed less than substantial services at one division also performed services at another geographically separate division, unless such checking would be reasonable under the circumstances (such as in the case where the employer transfers the individual). The Secretary may also permit employers to rely on records maintained by all leasing organizations providing the services of an individual in determining the amount of services performed by such individual as a nonemployee, unless, of course, the employer has reason to believe such records are not accurate. Also, in cases where determining the exact number of nonemployees performing substantial services would be burdensome due to the large numbers involved, the Secretary may permit employers to rely on a statistically valid sample performed by an independent third party.

With respect to the requirement that the employer have no top-heavy plans, the Secretary is to adjust this requirement to apply to the employee benefits to which the leasing rules apply under the Act. In such situations, the Secretary may substitute a comparable test applicable to employee benefits. For example, the recordkeeping exemption might not be available with respect to a type of employee benefit if at least 60 percent of that type of benefit were being provided to highly compensated employees.

For an employer that satisfies the requirements for recordkeeping relief, Congress intended that an employer need not treat an individual as a leased employee unless such individual provides the employer satisfactory evidence of entitlement to such treatment.

Deletion of regulatory authority

The Act deleted the rule providing regulatory authority to render the employee leasing rules inapplicable in certain circumstances. The recordkeeping exemption provided under the Act serves the purpose for which the regulatory authority was created.

Effective Date

In general, these new rules are effective with respect to services performed after December 31, 1986. The recordkeeping exemption, however, is to apply as if it were originally enacted as part of the employee leasing legislation in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), except that for plan years of recipients beginning before October 22, 1986, the only requirement for the relief is that the employer have no top-heavy plan. Further, the clarifying changes regarding crediting service and aggregating employers are effective as if originally part of the employee leasing legislation in TEFRA. The changes relating to employee benefits are effective when the new nondiscrimination rules apply to employee benefits. (See Part F.1. below.)

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

9. Federal Thrift Savings Plan (sec. 1147 of the Act and secs. 3121(v) and 7701(j) of the Code) [16]

Prior Law

Beginning in 1987, an employee is allowed to contribute up to 10 percent of the employee's rate of basic pay to the Thrift Savings Plan maintained by the Federal Government. Under certain specified circumstances, these employee contributions to the Thrift Savings Plan are not includible in the employee's income for the year of deferral, but rather are includible in income when distributed from the Plan. Under prior law, the tax treatment of an employee's contributions to the Plan was not specified in the Internal Revenue Code.

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[16] For legislative background of the provision, see: H.Rep. 99-841, Vol. II (September 18, 1986), p. 497 (Conference Report).

Reasons for Change

Congress believed it appropriate to specify in the Internal Revenue Code the tax treatment of the Thrift Savings Plan maintained by the Federal Government. Generally, it is preferable to include in the Internal Revenue Code provisions relating to Federal taxation.

Explanation of Provision

The Act provides, in the Internal Revenue Code, for the tax treatment of the Thrift Savings Plan maintained by the Federal Government. If the requirements regarding nondiscrimination and the limitation on elective deferrals are satisfied, an employee's contributions to the Plan are not treated as made available merely because the employee had an election to receive the amounts in cash. Therefore, the amounts deferred are not includible in an employee's income until distributed.

Effective Date

The provision is effective on the date of enactment (October 22, 1986).

Revenue Effect

The provision is estimated to have no effect on budget receipts.

F. Employee Benefit Provisions

1. Nondiscrimination rules for certain statutory employee benefit plans (sec. 1151 of the Act, secs. 79, 105, 106, 117(d), 120, 125, 127, 129, 132, 414, 505, 6039D, and 6652, and new sec. 89 of the Code) [1]

Prior Law

Overview

Under prior and present law, certain employer-provided employee benefits are excluded from the gross income of employees if provided under certain statutorily prescribed conditions. Similar exclusions generally apply for employment tax purposes.

Among those conditions that generally applied under prior law to the exclusion of employer-provided employee benefits was the requirement that employee benefits be provided on a nondiscriminatory basis. With the exception of the exclusion for employer-provided health insurance, no employee benefit exclusion was available unless the benefit was provided on a basis that did not favor certain categories of employees who were officers, owners, or highly compensated. Failure to satisfy the applicable nondiscrimination test for a specific benefit resulted in a denial of the tax exclusion for all employees receiving the benefit or only for the employees in whose favor discrimination was prohibited, depending on the benefit.

Separate nondiscrimination rules applied with respect to each benefit. An individual in whose favor discrimination was prohibited for one benefit may or may not have been such an individual for another benefit. Also, what constituted impermissible discrimination and the consequences of such discrimination differed with respect to different benefits.

Health benefit plans

Under prior law, a nondiscrimination test was not applied as a condition of the exclusion of health benefits provided by an employer under an insured plan, or as a condition of the exclusion of medical benefits and reimbursements provided under such insurance (secs. 105 and 106). However, if an employer provided its employees with health benefits under a self-insured medical reimbursement plan (sec. 105(h)), the exclusion of a medical reimbursement under such plan was available to a highly compensated individual only to the extent that the plan did not discriminate in favor of highly compensated employees. A self-insured health plan was discriminatory if it favored highly compensated individuals either as to eligibility to participate or as to benefits.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1151; H.Rep. 99-426, pp. 765-779; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1251; S.Rep. 99-313, pp. 646-665; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 498-538 (Conference Report).

Group-term life insurance plans

Under prior and present law, an exclusion is provided for the cost of group-term life insurance coverage (up to $50,000) under a plan maintained by an employer (sec. 79). Under prior law, if a group-term life insurance plan was determined to be discriminatory, the exclusion of the cost of $50,000 of group-term life insurance did not apply with respect to key employees. A discriminatory plan was one that discriminated in favor of key employees as to eligibility to participate or as to the type or amount of benefits available under the plan. Group-term life insurance benefits were not considered discriminatory merely because the amount of life insurance provided to employees bore a uniform relationship to compensation.

Group legal services plans

Under prior law, the exclusion for contributions to or services provided under an employer-maintained group legal services plan was available to employees only if (1) the plan benefited a class of employees that did not discriminate in favor of employees who were officers, shareholders, self-employed individuals, or highly compensated, and (2) the contributions or benefits provided under the plan did not discriminate in favor of such employees (sec. 120). In addition, under prior and present law, the exclusion is not available if more than 25 percent of the amounts contributed during a year may be provided for 5-percent owners (or their spouses or dependents). Under prior law, the exclusion for group legal services benefits expired for taxable years ending after 1985. (See Part F.3., below.)

Educational assistance programs

Under prior and present law, the amounts paid or expenses incurred (up to $5,000 a year under prior law) for an employee under an employer-provided educational assistance program are excluded from income (sec. 127). Under prior law, the exclusion was not available if the program benefited a class of employees that was discriminatory in favor of employees who were officers, owners, or highly compensated (or their dependents). Also, under prior and present law, the exclusion is not available if more than 5 percent of the amounts paid or incurred by the employer for educational assistance may be provided for 5-percent owners (or their spouses or dependents). Under prior law, the exclusion for educational assistance benefits expired for taxable years beginning after 1985. (See Part F.3., below.)

Dependent care assistance programs

Prior and present law provides an exclusion from income for amounts paid or incurred for an employee under a dependent care assistance program (sec. 129). The exclusion was not available unless (1) the program benefited a class of employees that did not discriminate in favor of employees who were officers, owners, or highly compensated (or their dependents), and (2) the contributions or benefits provided under the plan did not discriminate in favor of such employees. In addition, under prior and present law, the exclusion is not available if more than 25 percent of the amounts paid or incurred by the employers for dependent care assistance may be provided for 5-percent owners (or their spouses or dependents).

Welfare benefit funds

A voluntary employees' beneficiary association or a group legal services fund that is part of an employer plan is not exempt from taxation unless the plan of which the association or fund is a part meets certain nondiscrimination rules (sec. 505). (These nondiscrimination rules also apply for certain other purposes, such as the deductibility of contributions to a welfare benefit fund to provide post-retirement health benefits.) Under these rules, no class of benefits may be provided to a classification of employees that is discriminatory in favor of highly compensated employees. In addition, with respect to each class of benefits, the benefits may not discriminate in favor of highly compensated employees. A life insurance, disability, severance pay, or supplemental unemployment compensation benefit will not fail the benefits test merely because the amount of benefits provided to employees bears a uniform relationship to compensation.

Cafeteria plans

Under a cafeteria plan, as defined under prior law, a participant is offered a choice between cash and one or more employee benefits. The mere availability of cash or certain taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes if certain conditions are met (sec. 125). This cafeteria plan exception to the constructive receipt rules did not apply to any benefit provided under the plan if the plan discriminated in favor of highly compensated individuals as to eligibility to participate or as to contributions and benefits. In addition, under prior and present law, no more than 25 percent of the aggregate of the statutory nontaxable benefits provided to all employees under the cafeteria plan may be provided to key employees.

Eligibility tests

Under prior and present law, for purposes of the eligibility tests applicable to the employee benefits described above, the same rules applicable to the classification test for qualified plan coverage (sec. 410(b)(1)(B)) apply.

Reasons for Change

Under prior and present law, the tax-favored treatment of employer-provided employee benefits reduces the Federal income tax base and reduces Federal budget receipts. However, Congress believed these costs are justifiable if such benefits fulfill important social policy objectives, such as increasing health insurance coverage among taxpayers who are not highly compensated and who otherwise would not purchase or could not afford such coverage.

In order to achieve these objectives, Congress believed that effective nondiscrimination rules with respect to all employee benefits, including health insurance, were necessary because they permit the exclusion from income of employee benefits only if the benefits are provided to required levels of nonhighly compensated employees. Congress was concerned that the prior-law nondiscrimination rules did not require sufficient coverage of nonhighly compensated employees as a condition of the exclusions.

Under prior law, the definition of those individuals in whose favor discrimination was prohibited generally was vague, as it was unclear, for example, who qualified as an "officer," "owner," or "highly compensated employee." Similarly, little specific guidance was provided as to whether a particular pattern of coverage discriminated in favor of such individuals.

Therefore, Congress believed that the prior-law nondiscrimination rules should be modified to expand required coverage of nonhighly compensated employees particularly with respect to health and group-term life insurance plans and to provide more consistent principles for employee benefit exclusions. As a general rule, Congress believed that, to the extent possible, the nondiscrimination rules should require employers to cover nonhighly compensated employees to an extent comparable to the coverage of highly compensated employees.

Congress recognized that employers desire flexibility in designing employee benefit programs. However, Congress believed that flexibility should be provided only to the extent not inconsistent with the nondiscrimination rules. For example, if an employer operates, for legitimate economic reasons, multiple lines of business, the employee benefit structures in each line of business may differ because of historical trends within each industry. The Act permits employers to test the new nondiscrimination rules separately with respect to each line of business. Congress is concerned, however, that the line of business exception not be administered in a manner that circumvents Congress' premise that highly compensated employees should not be permitted to exclude employee benefits unless the employer's plan benefits a nondiscriminatory group of the employer's employees.

Explanation of Provision

Overview

The Act applies new nondiscrimination rules to statutory employee benefit plans. The term "statutory employee benefit plans" includes accident or health plans and group-term life insurance plans. At the election of the employer, the term also includes qualified group legal services plans, educational assistance programs, and dependent care assistance programs.

Under the new nondiscrimination rules, a plan generally is required to satisfy 3 eligibility tests—a 50-percent test, a 90-percent/50-percent test, and a nondiscriminatory provision test—and a benefits test. Alternatively, a plan may satisfy an 80-percent coverage test, provided it also satisfies the nondiscriminatory provision test.

Generally, each different option is a separate plan for testing purposes. However, the Act provides aggregation rules that allow plans to be tested together based on their relative values.

The Secretary is to prescribe rules regarding valuation of different benefits. With respect to health coverage, the Secretary is to prescribe a table prescribing the relative values of different types of health coverage.

If a plan is discriminatory, highly compensated employees are taxable on the value of the discriminatory excess. If the employer does not report such excess in a timely manner, the employer may be subject to an employer-level sanction.

For purposes of applying the new nondiscrimination rules, the Act provides generally applicable definitions of the following: (1) highly compensated employee; (2) employer (including the employee leasing rules); (3) line of business or operating unit (as the Act permits the new nondiscrimination rules to be applied separately to separate lines of business or operating units); and (4) employees who are excluded from consideration. These definitions, other than the line of business or operating unit rule, apply generally to all employee benefit plans, not only to statutory employee benefit plans.

In addition, the Act provides a benefits test applicable to dependent care assistance programs and includes in the definition of a cafeteria plan a plan offering a choice between nontaxable benefits.

The Act also applies to employee benefit plans generally new qualification and reporting requirements.

Applicability of new nondiscrimination rules

The Act provides new nondiscrimination rules applicable to statutory employee benefit plans. The term "statutory employee benefit plans" is defined to include group-term life insurance plans and accident or health plans (whether self-insured or insured through an insurance company). In addition, an employer may elect to treat one or more of the following as statutory employee benefit plans subject to the new nondiscrimination rules: qualified group legal services plans, educational assistance programs, and dependent care assistance programs.

New nondiscrimination rules

In general

Under the new nondiscrimination rules, a statutory employee benefit plan is required to satisfy either (1) 3 eligibility tests and a benefits test, or (2) an alternative test designed for certain plans with broad coverage.

A plan maintained by an employer that has no nonhighly compensated employees is considered to satisfy the new nondiscrimination rules.[2]

Eligibility tests

The Act provides 3 eligibility tests: a 50-percent test, a 90-percent/50-percent test, and a nondiscriminatory provision test.

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[2] A technical correction may be needed so that the statute reflects this intent.

50-percent test.—Under the 50-percent test, nonhighly compensated employees must constitute at least 50 percent of the group of employees eligible to participate in the plan. This requirement will be deemed satisfied if the percentage of highly compensated employees who are eligible to participate is not greater than the percentage of nonhighly compensated employees who are eligible.

For example, assume that an employer has 20 employees, 15 of whom are highly compensated employees. Because more than 50 percent of its workforce is highly compensated, the employer could make all employees eligible but still not satisfy the 50-percent test. However, if all employees are eligible, the employer would be deemed to satisfy the 50-percent test because the percentage of highly compensated employees and nonhighly compensated employees who are eligible is the same (i.e., 100 percent).

For purposes of satisfying the 50-percent test, comparable accident or health plans (as defined below) may be aggregated.

90-percent/50-percent test.—A plan does not satisfy the 90-percent/50-percent test unless at least 90 percent of the employer's nonhighly compensated employees are eligible for a benefit that is at least 50 percent as valuable as the benefit available to the highly compensated employee to whom the most valuable benefit is available. For purposes of this test, all plans of the same type (i.e., all benefits excludable under the same Code section) are aggregated. Thus, if an employee is eligible to participate in 2 or more plans of the same type, the employee is considered eligible for a benefit with a value equal to the sum of the values available under the plans for which the employee is eligible. On the other hand, if an employee is eligible to participate in only 1 plan, but may choose among more than 1 plan, such employee is considered eligible for a benefit with a value equal to the value of the benefit in the available plan with the most valuable benefit. In determining the highly compensated employee with the most valuable benefit available, benefits under all plans of the same type are aggregated in the same manner.

In certain situations, an employee may elect between plans of different types. For example, an employee may be able to elect (with or without a required employee contribution) to be covered under a health plan or a group-term life insurance plan, but not fully under both. In such circumstances, the value of the benefit available to an employee—determined in the manner described above—may be allocated among the different types of plans in any reasonable manner permitted by the Secretary.

For purposes of this 90-percent/50-percent test, available salary reduction[3] is not taken into account. (See "Cafeteria plans" below regarding the retention of the prior-law eligibility test for cafeteria plans generally.)

Nondiscriminatory provision test.—The third eligibility test provides that a plan may not contain any provision relating to eligibility to participate that by its terms or otherwise discriminates in favor of highly compensated employees. This third test is intended to disqualify arrangements only on the basis of discrimination that is not quantifiable. For example, if an employer maintains one health plan for its salaried employees and one health plan for its hourly employees, the fact that the hourly plan is quantifiably less valuable will not cause the salaried plan to fail the third eligibility test. On the other hand, if an employer provides unusual coverage for a rare condition to which only the owner of the employer is subject, such coverage may fail the third eligibility requirement, even if theoretically provided to all employees of the employer.

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[3] See note 5, below, for a discussion of the term "salary reduction".

Another example of a failure to satisfy the third eligibility test occurs if, under the facts and circumstances, the employer is satisfying the other nondiscrimination tests by providing or making available to nonhighly compensated employees benefits that clearly have less value than that ascribed to them under the Secretary's valuation tables (see "Valuation" below). For example, assume that an employer that offers certain standard health coverage to its highly compensated employees satisfies the first 2 eligibility tests by offering to its nonhighly compensated employees coverage for a condition that is extremely rare for individuals with the nonhighly compensated employees' characteristics, but has a substantial value under the Secretary's tables. Under these circumstances, the plans offering standard coverage to highly compensated employees would not be considered to satisfy the third eligibility test.

For a discussion of another application of the third eligibility test, see "Special accident or health plan rules—Family coverage" below.

Benefits test

Under the Act, a plan does not satisfy the benefits test unless the average employer-provided benefit received by nonhighly compensated employees under all plans of the employer of the same type (i.e., plans providing benefits excludable under the same Code section) is at least 75 percent of the average employer-provided benefit received by highly compensated employees under all plans of the employer of the same type.

For purposes of this test, the term "average employer-provided benefit" means with respect to highly compensated employees an amount equal to the aggregate employer-provided benefits received by highly compensated employees under all plans of the employer of the type being tested divided by the number of highly compensated employees of the employer (whether or not covered by any such plans). The term is defined in the same manner with respect to nonhighly compensated employees.

Alternative test

The Act also provides an alternative test that may be applied in lieu of the eligibility and benefits tests described above. If a plan benefits at least 80 percent of an employer's nonhighly compensated employees, such plan is considered to satisfy the new nondiscrimination rules. This alternative test will not apply unless the plan satisfies the nondiscriminatory provision test described above.

This alternative test applies only to insurance-type plans. Under the Act, the term "insurance-type plans" means accident or health plans and group-term life insurance plans.

For purposes of this alternative test, an individual will only be considered to benefit under a plan if such individual receives coverage under the plan; eligibility to receive coverage is not considered benefiting under the plan. Also, for purposes of this alternative test, comparable accident or health plans may be aggregated.

Definition of plan and aggregation of plans

In general

The definition of the term "plan" is relevant only for certain purposes. First, each separate plan is required to be valued separately. Second, the 50-percent test and the alternative 80-percent test are to be satisfied by each plan. However, for purposes of satisfying these two tests, comparable accident or health plans may be aggregated. See "Aggregation of accident or health plans" below.

Aside from the valuation issue, the definition of a plan is not relevant for purposes of the 90-percent/50-percent test or the benefits test because, for purposes of those tests, all plans of the same type are aggregated.

The definition of a plan also applies for purposes of the qualification requirements described below.

Separate plans

Under the Act, each option or different benefit offered is, except in the two instances described in "Single plan" below, treated as a separate plan. This means, for example, that if two types of insurance coverage vary in any way (including the amount of the employee contribution), they will be considered separate plans. Thus, in the case of health plans under which there are different levels or types of coverage, each separate level or type of health coverage is considered a separate plan under the nondiscrimination rules. Also, each health maintenance organization is considered a separate plan due to the difference in prescribed providers of services.

In addition, an employee who has available or receives coverage both for himself and his family is to be treated as having available or received 2 separate coverages: individual coverage with respect to himself, and family coverage with respect to his family. Each coverage is considered provided under a separate plan.

Also, limitations on family coverage give rise to separate plans. For example, if an employer offers "employee plus 1 family member" health coverage and "employee plus 2 or more family members" health coverage, there are 3 plans: (1) employee coverage, (2) coverage of 1 family member, and (3) coverage of additional family members.

In addition, if 2 plans of the same employer provide overlapping coverage, an employee technically eligible for or covered by both plans is not to be considered fully eligible for or covered by both. With respect to 1 of the plans, the employee is to be considered only partially eligible or covered under rules prescribed by the Secretary.

Single plan

Under the Act, 2 or more plans that are identical in all respects, except for the group of employees covered, may be treated as a single plan, even if, for example, they are established pursuant to separate written documents.

Further, for purposes of determining what constitutes a single plan, 2 exceptions are provided to the rule that insurance coverage (or available noninsurance benefits) be identical within a plan.

First, in the case of group-term life insurance, the provision of insurance coverage that varies in proportion to compensation is not to be considered as the provision of different options or benefits with respect to such varying coverage. Thus, for example, if an employer provides all employees with group-term life insurance equal to one-times compensation, such arrangement may be considered one plan. For this purpose, the definition of and limitation on compensation applicable for purposes of qualified plans applies. See Parts B.1. and D., above.

Under the second exception, if accident or health coverage available or provided to employees is identical except that the employer subsidy is proportionately reduced for employees who normally work less than 30 hours per week, such arrangement may be considered a single plan. The permissible proportionate reduction corresponds to the special rule described below for the benefits test and the 50-percent component of the 90-percent/50-percent test. If an employee normally works at least 22½ hours per week but less than 30 hours per week, the second exception applies if the employer subsidy is reduced by no more than 25 percent. If the employee normally works less than 22½ hours per week, the second exception applies if the employer subsidy is reduced by no more than 50 percent. If the second exception is used, it is required to be used on a uniform, nondiscriminatory basis with respect to all employees. Of course, this rule does not affect the benefit actually made available or provided for purposes of any other tests.

Assume, for example, that an employer makes 1 group health insurance policy available to all of its employees. Generally, for a $100 contribution, employees receive coverage with a value of $1,100. Under these circumstances, the employer subsidy is $1,000. Assume further that the employer employs certain individuals who normally work 20 hours per week. Under the rule described above, if the employer required a $600 contribution from these individuals—making the employer subsidy $500 (50 percent of the employer subsidy for the other employees)—such individuals may be considered eligible for the same plan as is available to the other employees, even though the required employee contribution is different.

The second exception described above does not apply in any plan year unless during such year more than 50 percent of the nonexcludable employees (determined without regard to plan provisions) normally work more than 30 hours per week. (For a discussion of which employees are nonexcludable, see below.) Also, the second exception allowing a proportionate reduction in benefits does not apply to elective contributions.

Restructuring plans

Under the Act, under rules prescribed by the Secretary, for purposes of determining what constitutes a single plan, employers may structure options in different ways as long as all coverage within a plan is identical. For example, if the deductible for all highly compensated employees is $200 and the deductible for all nonhighly compensated employees is $50, it is not necessary to classify the $200 deductible coverage as a separate plan that covers only highly compensated employees. Instead, the employer could classify the coverage as 1 plan for all employees providing coverage for expenses in excess of a $200 deductible and a second plan covering costs between $50 and $200 for only nonhighly compensated employees. Such restructuring may be helpful in demonstrating compliance with the nondiscrimination rules without resort to the aggregation rules described below.

Aggregation of accident or health plans

For purposes of satisfying the 50-percent eligibility test, 1 or more accident or health plans ("nonhelper plans") that separately do not satisfy the 50-percent test may be aggregated with 1 or more comparable accident or health "helper plans" that are not aggregated with other nonhelper plans for this purpose. A "helper plan" is any plan in the group of aggregated plans that satisfies the 50-percent test without regard to aggregation. A helper plan is considered comparable to a group of nonhelper plans if the value of the employer-provided coverage available to each eligible employee in the helper plan is at least 95 percent of the value of the employer-provided coverage available to each eligible employee in the nonhelper plan in the group of aggregated plans with the highest such value.

For purposes of the 80-percent test, the general rule is that a group of plans are comparable and may be aggregated if the value of the employer-provided coverage provided to each covered employee in the plan with the lowest such value is at least 95 percent of the value of the employer-provided coverage provided to each covered employee in the plan with the highest such value. However, if a plan with a greater value than permitted under the previous sentence satisfies section 89(d)(2) based on actual coverage provided rather than on eligibility, such plan may be aggregated with the group of less valuable plans for purposes of the 80-percent test.

Under rules prescribed by the Secretary, if an employee is eligible for or receives coverage under more than 1 accident or health plan, then, for purposes of the 50-percent test and the 80-percent test, such plans are to be considered 1 plan with respect to such employee.[4] For example, assume that an employer maintains two plans: one covering all employees with a value of $950 and a second covering only highly compensated employees with a value of $1,000. The highly compensated employees receiving benefits from both plans are to be treated for purposes of the 50-percent test and the 80-percent test as receiving $1,950 of benefits from one plan while the nonhighly compensated employees are to be treated as receiving $950 of benefits from a separate plan. Under the rules described above, these plans would not be comparable so that the plan covering the highly compensated employees would satisfy neither the 50-percent test nor the 80-percent test. For a discussion of the sanction applicable to such a plan, see "Sanction for discrimination" below.

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[4] A technical correction may be needed so that the statute reflects this intent.

In addition, the special part-time employee rule applicable for purposes of defining what constitutes a plan also applies for comparability purposes. Thus, if two plans that would be comparable but for the fact that under the rules described above the employer-provided benefit in both of such plans is proportionately reduced for employees who normally work less than 30 hours per week, the plans are to be considered comparable.

Valuation

In general

For purposes of the nondiscrimination rules, in the case of an insurance-type plan (i.e., an accident or health plan or a group-term life insurance plan), an employee's employer-provided benefit is the value of the coverage provided to or on behalf of such employee, to the extent attributable to contributions made by the employer. For example, the value of a health plan, whether insured or self-insured, is the value of the insurance, not the services or the amount of claims proceeds received by a particular employee. In the case of any plan other than an insurance-type plan, an employee's employer-provided benefit is defined as the value of the benefits provided to or on behalf of such employee, to the extent attributable to contributions made by the employer. Except as otherwise provided (sec. 89(g)(3)(D)) with respect to the 90-percent/50-percent test and the special part-time employee rule, employer contributions include elective contributions under a cafeteria plan.[5]

Accident or health plans

With respect to accident or health coverage, the Secretary is to promulgate tables that establish the relative values of plans with certain characteristics. Such tables may use as a reference point an identifiable standard plan. These tables are to provide the exclusive means of valuing accident or health coverage.

Such tables are to be adjusted in certain instances to take into account the specific coverage and group involved. For example, in determining the value of discriminatory coverage, the actual costs expended by the employer may be taken into account and allocated among all coverages, including the discriminatory coverage, on the basis of the relative values of such coverages, as determined under the tables. Another example is that in certain instances it may be appropriate to adjust the table value of coverage based on whether such coverage would have been provided at group rates by an insurance company. Thus, an individually designed plan may have a higher value than a group plan with the same characteristics.

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[5] The terms "elective contribution" and "salary reduction" are used interchangeably to refer to the provision of nontaxable benefits in lieu of available taxable benefits. Nontaxable benefits provided by an employer on a nonelective basis, or through a choice among nontaxable benefits only, are, of course, employer-provided benefits but are not considered elective contributions or provided through salary reduction.

Special group-term life insurance rules

Under the Act, certain special valuation rules apply for purposes of applying the nondiscrimination rules to group-term life insurance plans. Other special rules apply for purposes of valuing life insurance coverage determined to be discriminatory. In all cases, all employer-provided coverage (including coverage over $50,000) is taken into account.

In applying the benefits test and the 50-percent component of the 90-percent/50-percent test to a group-term life insurance plan, the first step in valuing the employer-provided benefit under a plan is to determine the amount of group-term life insurance coverage that is employer-provided. The next step is to determine the value of the employer-provided coverage under section 79(c) as if the insured were age 40. Except in the case where group-term life insurance plans are aggregated with plans of a different type for purposes of the benefits test (see discussion below), this value may then be adjusted depending on the compensation of the employee. The permissible adjustment is made by multiplying the amount by a fraction the numerator of which is a uniform amount for all plans and the denominator of which is the employee's compensation.

For purposes of the above rules, the definition of compensation (including the limitation on the amount that may be taken into account) applicable to qualified plans (see Part B.1. and Part D., above) applies.

In determining the value of discriminatory coverage, the special valuation rules described above—regarding the age 40 assumption and the compensation adjustment—do not apply. Instead, the value of the discriminatory coverage is the greater of the cost of the coverage under section 79(c) or the actual cost of the coverage. The same special rules also do not apply for purposes of determining the value of any inclusion amount attributable to a failure to satisfy the qualification requirements described below or for purposes of determining the amount subject to the employer-level sanction described below.

Other benefits

The valuation of other benefits, such as educational assistance, is to be based on general valuation principles.

Valuation unnecessary

In certain instances, employers need not value their accident or health plans or group-term life insurance plans or, alternatively, the number of plans that need to be valued can be significantly reduced.

For example, assume that an employer makes available to all of its employees a group of 10 health plans. In such a situation, it generally is not necessary to value the plans for purposes of the eligibility tests; the plans all pass. Assume further that for the entire year the percentage of nonhighly compensated employees in each plan is at least 75 percent of the percentage of highly compensated employees in the plan. Because the definition of a plan generally requires all features to be identical, each of these plans individually would pass the benefits test; thus, in the aggregate, they pass the benefits test. No valuation is necessary to make this determination.

In other situations, this approach can reduce the number of plans that have to be valued. For example, assume the same facts described above except that in 1 of the 10 plans, the percentage of nonhighly compensated employees covered is less than 75 percent of the percentage of highly compensated employees covered. The employer could aggregate with the tenth plan only so many of the other 9 plans as would be necessary to satisfy the benefits test with respect to that group of plans. Thus, only that group of plans would have to be valued to demonstrate compliance with the benefits test.

Sanction for discrimination

Inclusion in income

Under the Act, in the case of a discriminatory statutory employee benefit plan, highly compensated employees are required to include in gross income the discriminatory excess. Congress provided rules regarding the definition of the discriminatory excess, how to allocate the excess among highly compensated employees, and the year of inclusion.

The discriminatory excess is defined as the amount of the otherwise nontaxable employer-provided benefit (including benefits purchased with elective contributions) that would have to have been purchased with after-tax employee contributions by the highly compensated employees in order for all of the nondiscrimination tests to be satisfied. In applying this definition, the objective nondiscrimination tests are, except as provided by the Secretary, to be applied in the following order: the 50-percent test, the 90-percent/50-percent test, and then the benefits test. Alternatively, the definition of the discriminatory excess may be applied to the alternative 80-percent test. The determination of the discriminatory excess with respect to the third eligibility test (the nondiscriminatory provision test) is to be made under rules prescribed by the Secretary. See the discussion of these tests above.

Any discriminatory excess determined with respect to the benefits test is to be allocated to highly compensated employees by reducing the otherwise nontaxable employer-provided benefit (again including elective benefits) of highly compensated employees (beginning with the employees with the greatest such benefit) until the plan (or plans) being tested would not be discriminatory under the benefits test.

The discriminatory excess is includible in the employee's income in the employee's taxable year with or within which the plan year ends.

For purposes of determining and allocating the discriminatory excess with respect to a group-term life insurance plan, coverage over $50,000 is considered nontaxable. Thus, to the extent that the discriminatory coverage does not exceed the total coverage over $50,000, the effect of a finding of discrimination is simply the inclusion in income of the excess, if any, of the actual cost of the discriminatory coverage over the cost of such coverage under section 79(c). For example, assume an employee receives $150,000 of coverage, the $100,000 excess over $50,000 being included in income at the cost determined under section 79(c). Assume further that $25,000 of such employee's coverage is determined to be discriminatory. The effect of this finding of discrimination is that the excess, if any, of the actual cost of such $25,000 of coverage over the section 79(c) cost of such coverage is included in the employee's income (in addition to the section 79(c) cost of the $100,000 of coverage (i.e., the amount over $50,000)). See discussion above for the rule regarding valuing discriminatory group-term life insurance coverage.

An example with respect to the 50-percent test will illustrate how the excess benefit approach applies to the eligibility tests. Assume that an employer maintains 2 health plans, one (Plan A) available only to highly compensated employees and the other (Plan B) available to an equal number of nonhighly compensated employees. Under Plan A, the value of the available employer-provided coverage is $1,500; under Plan B, the value is $950. In this example, Plan A fails the 50-percent test. However, if $500 of the $1,500 in coverage available under Plan A were available on an after-tax basis, the value of available employer-provided coverage under Plan A would be $1,000 and, under the rules regarding aggregation of plans, Plan A and Plan B could then be aggregated for purposes of the 50-percent test. Aggregated, they would satisfy the test. Thus, in this example, any highly compensated employee receiving over $1,000 of employer-provided coverage is taxable on that excess as an excess benefit. No highly compensated employee is taxable merely because more than $1,000 of employer-provided coverage is available, but not provided (because, for example, the employee declines to make the required employee contribution).

Employer sanction

Except to the extent provided by the Secretary, if an employer (including an employer exempt from tax) does not report the discriminatory excess to the affected employees and the IRS on Forms W-2 by the due date (with any extension) for filing such Forms W-2, all benefits of the same type provided to such employees are subject to an employer-level sanction without regard to whether the employees report some or all of the benefits as income. Under this sanction, the employer is liable for a tax at the highest individual rate on the total value of benefits of the same type provided to employees with respect to whom the employer failed to report the discriminatory excess. With respect to group-term life insurance, the value of benefits for this purpose is the greater of the table cost (sec. 79(c)) or actual cost of all coverage.[6] This tax is not deductible and may not be offset by credits or deductions in any manner. This tax, however, does not apply if the employer can demonstrate that the failure to report was due to reasonable cause, such as a reasonable difference in the valuation of health benefits prior to the issuance of valuation rules.

This tax applies in addition to any other penalties or taxes otherwise applicable.

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[6] A technical correction may be needed so that the statute reflects this intent.

For a description of the general reporting requirement applicable to benefits that are includible in income due to the new nondiscrimination rules or the new qualification rules described below, see discussion below.

Special rules applicable to all tests and statutory employee benefit plans

There are four special rules applicable to all of the tests and plans described above. These four rules—

(1) provide a uniform definition of "highly compensated employee";

(2) provide a uniform definition of "employer";

(3) allow the nondiscrimination rules to apply on a line of business or operating unit basis; and

(4) define classes of employees who are excluded from consideration in applying the nondiscrimination rules.

Highly compensated employees

Under the Act, a uniform definition of the term "highly compensated employee" is provided. This definition applies for purposes of statutory employee benefit plans (including the sanction for violation of the rules regarding continuing health coverage); qualified tuition reduction programs; qualified group legal services plans; cafeteria plans; educational assistance programs; dependent care assistance programs; fringe benefit programs providing no-additional-cost services, qualified employee discounts, or employer-operated eating facilities (sec. 132); welfare benefit funds; qualified plans; and other provisions listed in the Act.

In general, an employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) received more than $75,000 in annual compensation from the employer; (3) received more than $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (generally as defined in sec. 416(i)). Under this definition, every employer is to have at least 1 officer treated as a highly compensated employee for any year; if necessary, this means that the compensation floor required for such status is not to apply to 1 individual. Also, the $50,000 and $75,000 thresholds are to be adjusted at the same time and in the same manner as the adjustments to the dollar limit on benefits under defined benefit pension plans.[7]

In addition, a former employee is to be treated as a highly compensated employee if such employee was highly compensated at the time of separation from service or at any time after attaining age 55.

As noted, the definition of the term "highly compensated employee" is the same as the definition used with respect to qualified plans. (For a more detailed description of the definition, see Part B.7., above.) One clarification applies to employee benefits, however, that does not apply to qualified plans. With respect to those benefits for which family coverage is treated as a benefit separate from employee coverage, such as accident or health benefits, the special rule aggregating family members is modified. In such instances, where a family member would be aggregated with a 5-percent owner or 1 of the top 10 highly compensated employees under the qualified plan rules, such family member is to be treated as a nonemployee family member under rules prescribed by the Secretary.

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[7] A technical correction may be needed so that the statute reflects this intent.

Definition of employer

Aggregation

The Act provides that related employers are treated as a single employer for purposes of all aspects of the employee benefit rules, including the nondiscrimination requirements (sec. 414(b), (c), (m), and (t)). In addition, leased employees are treated for the same purposes as employees of the person or organization for whom they perform services (sec. 414(n)). The qualified plan exemption from the employee leasing rules with respect to individuals covered by a safe-harbor plan (sec. 414(n)(5)) does not apply to employee benefits. For further discussion of the employee leasing rules and their applicability to employee benefits, see Part E.8. above. The Act also provides that the Secretary's general regulatory authority to prevent abuse of employee benefit requirements applies (sec. 414(o) and (t)).

Under the Act, the rules described above, which under prior law applied to qualified plans, apply also to statutory employee benefit plans, qualified tuition reduction programs, qualified group legal services plans, cafeteria plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits (sec. 132), continuation of health care requirements,[8] welfare benefit funds, and employee achievement awards.

Special rule for certain dispositions and acquisitions

The Act contains a special transition rule for certain dispositions or acquisitions of a business. Under the Act, if a person becomes or ceases to be a member of a controlled group (sec. 414 (b) and (c)) or affiliated service group (sec. 414(m)), the nondiscrimination rules will, with respect to a plan maintained by the person or group, be deemed satisfied during the transition period, provided that (1) the nondiscrimination rules were satisfied immediately before the acquisition or disposition, and (2) the coverage under the plan (or under another plan on which the plan relied to satisfy the nondiscrimination rules) does not change significantly during the transition period (other than by reason of the acquisition or disposition). The transition period begins on the date of the acquisition or disposition and ends on the last day of the first plan year beginning after the transaction.

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[8] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H.Con.Res. 395 which passed the House and Senate in the 99th Congress.

This rule is not intended to compel employers to determine if the nondiscrimination rules were satisfied immediately prior to any disposition or acquisition to which the rule could apply. For example, if an insignificant disposition or acquisition occurs during a transition period with respect to a prior disposition or acquisition, an employer might want to apply the special rule throughout the existing transition period, rather than determine if the nondiscrimination rules are actually satisfied immediately prior to the subsequent disposition or acquisition. Thus, employers may apply the nondiscrimination rules without regard to this special rule.

In addition, this special rule is to be applied under rules prescribed by the Secretary in a manner consistent with the purposes of the nondiscrimination rules. For example, this special rule is to grant relief only with respect to that part of the nondiscrimination rules affected by the disposition or acquisition. For example, if the employer applies the rules separately to separate lines of business, and the employer disposes of one of such incorporated lines of business, the effect of this rule may simply be to allow the employer to continue to apply the nondiscrimination rules separately to the other lines of business during the transition period. This result occurs because, although the disposition of 1 line of business can affect an employer's option to apply the nondiscrimination rules separately to other lines of business (e.g., by causing a plan to fail the classification test on an employer-wide basis), such disposition does not affect the application of the nondiscrimination rules to the other lines of business if such lines of business can continue to be tested separately. This assumes that the identity of the highly compensated employees is not affected by the disposition of the line of business. See the discussion below relating to lines of business or operating units.

Self-employed individuals

For purposes of all nondiscrimination rules applicable to qualified group legal services plans, educational assistance programs, and dependent care assistance programs, self-employed individuals are treated as employees. An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer and a partnership is treated as the employer of each partner.

Line of business or operating unit rules

In general

Under the Act, if an employer is treated as operating separate lines of business or operating units for a year, the employer may apply the new nondiscrimination rules separately to each separate line of business or operating unit for that year. This rule does apply, however, to any plan that does not satisfy the classification test on an employer-wide basis. (For a discussion of the classification test, see Part B.1., above.)

In general, an accident or health plan that would, tested separately, fail the classification test may be aggregated with 1 or more other accident or health plans ("helper plans") for purposes of satisfying the classification test, provided that the value of the employer-provided coverage available to each eligible employee in each helper plan is at least 100 percent of the value of the employer-provided coverage available to each eligible employee in the plan that would otherwise fail the classification test. This aggregation rule is to be applied in the same manner as the aggregation rule described above with respect to the 50-percent test.

Definitions of line of business and operating unit

The Secretary is to prescribe by regulation what constitutes a separate line of business or operating unit. Congress generally intended that a line of business or operating unit include all employees necessary for the preparation of property for sale to customers or for the provision of services to customers. Thus, a headquarters or home office is not to be treated as a separate line of business or operating unit. Certain exceptions to the general rule (but not to its application to headquarters or home offices) may be established by regulation where an employer has 2 operations that are vertically integrated and that traditionally are operated by unrelated entities.

In addition, whether claimed lines of business or operating units are separate and bona fide is a facts and circumstances determination requiring examination of each particular situation. Differences and similarities between the services provided and products produced by such claimed lines of business or operating units are, of course, important considerations. Also, the manner in which the employer organizes itself is relevant. Thus, if an employer fails to treat itself as comprised of separate lines of business or operating units and treats employees from different claimed lines or units in an equivalent fashion for certain purposes, such as for coverage under an employer-wide qualified plan, it may not be appropriate to allow such activities to be treated as separate lines of business or operating units.

Notwithstanding the general rules described above, the line of business or operating unit concept is not to be used to undermine the nondiscrimination rules. Thus, for example, certain job classifications (such as hourly employees or leased employees) are not considered to be separate lines of business or operating units. Also, for example, secretaries and other support service personnel are not to be treated as in a line of business or operating unit separate from the lawyers, other professionals, or other employees for whom such personnel perform services, and nurses and laboratory personnel are not to be treated as in a line of business or operating unit separate from the medical doctors for whom they perform services. In addition, the members of an affiliated service group (sec. 414(m)) may not be treated as separate lines of business or operating units.

Also, the Act provides that an operating unit will not be recognized for purposes of these rules unless, for a bona fide business reason, it is separately operated in a geographic area significantly separate from another operating unit in the same line of business. For example, two plants in the same city would not be considered to be in significantly separate geographic areas and thus could not be considered separate operating units if both were in the same line of business.

Separate maintenance

A line of business or operating unit will generally be recognized as separate for purposes of the nondiscrimination rules if it is separately maintained for bona fide business reasons under the rules described above. However, notwithstanding those rules, a line of business or operating unit will not be treated as separate unless it also satisfies the following 3 requirements:

(1) such line of business or operating unit has at least 50 employees;

(2) the employer notifies the Secretary that such line of business or operating unit is being treated as separate; such notification is to be made annually and is to include the basis for the position that the employer is maintaining a separate line of business or operating unit; and

(3) the line of business or operating unit satisfies guidelines prescribed by the Secretary or the employer obtains a determination from the Secretary that the line of business or operating unit may be treated as separate.

Safe harbor

The Act provides a safe-harbor rule under which a separate line of business or operating unit is treated as meeting the third requirement listed in "Separate maintenance," above. A line of business or operating unit satisfies this safe-harbor rule if the "highly compensated employee percentage" of the line of business or operating unit is (1) not less than one-half ("50-percent rule"), and (2) not more than twice ("200-percent rule") the percentage of all employees of the employer who are highly compensated. For purposes of this requirement, the 50-percent rule will be deemed satisfied if at least 10 percent of all highly compensated employees of the employer are employed by the line of business or operating unit. The term "highly compensated employee percentage" means the percentage of all employees performing services for a line of business or operating unit who are highly compensated employees.

If an employer applies the nondiscrimination rules separately to a line of business or operating unit that does not fall within the safe-harbor rule, this may trigger additional reporting requirements.

Guidelines and determinations

The guidelines prescribed by the Secretary for purposes of the third requirement described in "Separate maintenance" above are intended to identify those claimed lines of business or operating units deserving of special scrutiny. For example, if a plan maintained for a claimed line of business or operating unit is significantly better or worse than plans for other lines of business or operating units, such a situation deserves special scrutiny. Also, if a disproportionate percentage of the accrued benefits under the qualified plans of a claimed line of business or operating unit is for highly compensated employees, such employer's claim of a separate line of business or operating unit is to be specially examined.

As noted, if a claimed line of business or operating unit does not satisfy the safe-harbor rule or the applicable guidelines, then the claimed line of business or operating unit will not be recognized for purposes of the nondiscrimination rules unless the employer obtains a determination from the Secretary (e.g., by determination letter or private letter ruling) that such line of business or operating unit is operated separately for bona fide business reasons.

Special rules regarding lines of business and operating units

Combining lines of business

For purposes of satisfying the 50-employee requirement or the safe-harbor rule (or the guidelines, if permitted by the Secretary), a line of business or operating unit may be combined with another line of business or operating unit. Any plan maintained for employees of one of the combined lines of business or operating units is required to satisfy the nondiscrimination rules with respect to the aggregate entity.

Excludable employees

For purposes of determining (1) the number of employees in a line of business or operating unit; (2) the highly compensated employee percentage of a line of business or operating unit; and (3) the percentage of all employees of the employer who are highly compensated, an employer is to disregard the categories of employees that are disregarded for purposes of determining which employees are highly compensated employees. (See Part B.7., above.)

Headquarters employees

The Act clarifies the proper treatment of employes of a headquarters or home office and of other employees serving more than 1 line of business or operating unit (e.g., payroll personnel). Like all other employees, these employees are to be allocated to 1 line of business or operating unit. Generally, this allocation is, under rules prescribed by the Secretary, to be made in accordance with their performance of services. Thus, if a majority of an employee's services are performed for a particular line of business or operating unit, such employee is to be allocated to that line of business or operating unit.

Other employees performing services for more than 1 line of business or operating unit are to be allocated in 1 of 2 ways. First, the employer may allocate such employees on a pro rata basis among its lines of business or operating units, under rules prescribed by the Secretary. Alternatively, such employees may be allocated to any 1 line of business or operating unit for which they perform substantial services provided that such allocation does not cause any line of business or operating unit to violate, continue to violate, or further violate the 50-percent rule or the 200-percent rule provided in the safe-harbor rule. Thus, for this purpose, the 50-percent rule and the 200-percent rule serve as substantive rules, not as safe harbors. This means, for example, that if any lines of business or operating units do not pass the 50-percent rule, highly compensated employees at the home office or headquarters who do not perform a majority of their services for any particular line of business or operating unit are to be allocated first to such lines of business or operating units. This also means that in no event may such highly compensated employees be allocated to any line of business or operating unit if after such allocation the 200-percent rule would be violated (regardless of whether it was violated prior to such allocation).

Allocation of all employees

The Act clarifies that if an employer is using the separate line of business or operating unit rule with respect to any plan, all employees are to be considered part of a line of business or operating unit. Thus, it would not be permissible to maintain that an employer has, in addition to 1 line of business with 50 employees, 10 other employees who are not part of any line of business or operating unit and who would be tested separately. The 10 other employees would have to be treated as part of 1 or more lines of business or operating units. Such lines of business or operating units would have to be aggregated with the 50-employee line of business in order to satisfy the requirement that to be tested separately, a line of business or operating unit is required to have at least 50 employees.

Attribution of benefits

The Act requires that benefits attributable to service for a line of business or operating unit are to be considered as provided by that line of business or operating unit. For purposes of these rules, an employee who performs services for more than one line of business or operating unit, but is allocated to one line of business or operating unit under the rules described above, is to be considered to perform services solely for that line of business or operating unit.

Excluded employees

In general

Under the Act, certain classes of employees are disregarded in applying the nondiscrimination rules if neither the plan, nor any other plan of the same type, is available to any employee in such class. The classes of excluded employees are (1) in the case of an accident or health plan (other than with respect to noncore benefits), employees who have not completed at least 6 months of service (or such shorter period of service as may be specified in the plan); (2) in the case of any other statutory employee benefit plan (including an accident or health plan with respect to noncore benefits), employees who have not completed 1 year of service (or such shorter period of service as may be specified in the plan); (3) employees who normally work less than 17½ hours per week (or such lesser amount as may be specified in the plan); (4) employees who normally work no more than 6 months during any year (or such lesser amount as may be specified in the plan); and (5) employees who have not attained age 21 (or such lower age as may be specified in the plan). In addition, employees included in a unit of employees covered by a collective bargaining agreement are disregarded if neither the plan nor any other plan of the same type is available to any employee in that unit. Finally, nonresident aliens who receive no United States source earned income are disregarded, regardless of whether any such individuals are eligible under a plan.

Conditions for exclusions

In general.—In applying the nondiscrimination rules, an employer may exclude from consideration a category of employees only if no employee in that category is eligible under the plan being tested or any other plan of the employer of the same type. Plans are treated as being of the same type if their benefits are eligible to be excluded from income under the same section of the Code. Thus, if an employer maintains 2 group-term life insurance plans, only 1 of which excludes employees with less than a year of service, the employer is not permitted to exclude from consideration employees with less than a year of service in testing either plan for compliance with the nondiscrimination rules.

In the case of a cafeteria plan, for purposes of applying the cafeteria plan nondiscrimination rules, an employer may exclude a category of employees from consideration only if all employees in such category are excluded with respect to all options offered by the cafeteria plan.

The Act contains certain exceptions described below to the rule that if even one excludable employee is eligible under a plan, all employees who are excludable on the same basis (and on no other basis) as the eligible employee are to be taken into account in applying the nondiscrimination rules to the plan and any other plan of the same type.

Core and noncore benefits.—If a plan offering noncore accident or health benefits excludes employees with less than a year of service, the employer is not required to take into consideration employees with less than a year of service merely because another plan maintained by the employer offering core accident or health benefits has a shorter service requirement. Noncore accident or health benefits consist of coverage for dental, vision, psychological and orthodontia expenses and elective cosmetic surgery.

For purposes of the initial service rules, core accident or health benefits may be considered provided under a separate plan from noncore benefits.

Line of business.—If an employer elects to apply the nondiscrimination rules on a separate line of business or operating unit basis, the employees who are excluded from consideration are determined on a separate line of business or operating unit basis. Thus, for example, if (1) an employer maintains a statutory employee benefit plan for a line of business, (2) the nondiscrimination rules are applied to the plan on a line of business basis, and (3) all plans providing benefits of the same type to employees in that line of business exclude all employees who have not attained the age of 21, then the employer is to exclude from consideration, in applying the nondiscrimination rules to the plan, all employees in that line of business who have not attained age 21, even if the employer maintains a plan of the same type that does not impose an age requirement for employees in another line of business.

Collective bargaining agreement.—If any employee in a unit of employees covered by a collective bargaining agreement is eligible under a plan, then all employees in that unit are required to be taken into account for purposes of applying the nondiscrimination rules to all plans of the same type. However, the fact that employees in one unit must be taken into account with respect to a plan does not alone mean that employees in another unit must be taken into account with respect to the same plan.

Nonresident aliens.—Nonresident aliens with no United States source income are disregarded regardless of whether any such individuals are covered by the plan being tested or by any other plan of the same type.

Separate testing.—The Act also provides that if, for purposes of applying the nondiscrimination rules to a plan, certain employees ("excludable employees") could be excluded from consideration based on the age and service requirements but for the fact that certain of such excludable employees are covered by that plan or another plan of the same type, the excludable employees may be disregarded for purposes of testing the plan if the nondiscrimination rules are satisfied with respect to the excludable employees, treating the excludable employees as the only employees of the employer.

Under the rule described above, an employer may test all such excludable employees separately. Alternatively, an employer may elect to test 1 group of excludable employees separately without testing all excludable employees separately if such group is defined in a nondiscriminatory manner solely by reference to the age or service requirements. For example, an employer may elect to test separately all employees excludable solely on the grounds that they do not have 6 months of service, but not include in such testing group employees excluded under the other age and service rules. (Of course, in this case, the rule permitting employees to be disregarded if the separate testing requirement is satisfied only applies to employees excludable on the grounds that they do not have 6 months of service.) Also, an employer may test separately a group of employees who would pass less restrictive age or service requirements. For example, an employer could test separately all employees excludable solely on the grounds that they are not age 21, but who are at least age 18.

Supplemental employees.—Treasury regulations are to provide a limited exception to the rule that employees who otherwise are excludable as not having 6 months (or 1 year) of service or not normally working more than 6 months a year may not be excluded if any plan of the same type does not exclude such employees. The limited exception will be available if (1) substantially all employees of the employer (other than supplemental employees) generally are eligible to participate in an accident or health plan (or other employee benefit plan) within 30 days after the date of hire; (2) the employer also employs supplemental employees who generally do not work more than 6 months per year; (3) the supplemental employees generally are not rehired if they have previously been supplemental employees; and (4) the supplemental employees do not exceed 15 percent of the employer's workforce.

Under this limited exception, supplemental employees who are (1) retired employees of the employer who are covered under an accident and health plan of the employer maintained for retirees, or (2) students hired by the employer under a work-study program, may be disregarded in determining whether the employer's employee benefit plans satisfy the nondiscrimination requirements. Of course, this limited exception would not be available if any supplemental employees are eligible to participate in any employee benefit plan of the employer (other than a plan maintained for retired employees).

Initial period of service

An employer is to exclude an employee, on the grounds that such employee has not satisfied the required period of initial service, during the period prior to the first day of the calendar month immediately following the actual satisfaction of the initial service requirement. (Of course, subject to the exceptions described above, this exclusion does not apply if any employee is eligible under any plan of the same type prior to the first day of the calendar month immediately following the actual satisfaction of the initial service requirement.) For example, assume an employer required 30 days of service for participation in a health plan, but did not allow participation to begin other than on the first day of a calendar month. Assume further that the employer hires 2 employees, A on July 2 and B on July 3. Under the terms of the employer's plan, A would be a participant on August 1 and B would be a participant on September 1. Thus, A is a participant after 30 days of service while B has to wait 60 days. Because of the special rule allowing B to be disregarded prior to the first day of the next month following satisfaction of the period of service requirement, B is not taken into account for nondiscrimination purposes until September 1, even though B would have 30 days of service after August 1.

The exclusion described above also may be applied with respect to the first day of a period of less than 31 days specified by the plan.[9] For example, assume an employer required 60 days of service for participation in a health plan, but did not allow participation to commence other than on the first day of 4-week periods. As in the prior example, such employer is to exclude employees during the period prior to the first day of the first 4-week period following satisfaction of the 60-days-of-service requirement.

The Act also clarifies that the 6-month and 1-year service requirements (or shorter service requirements of an employer) are satisfied if an employee is employed continuously for the required period without regard to the number of hours or days worked. A period during which an employee does not perform services for the employer counts toward this service requirement unless there has been a bona fide, indefinite cessation of the employment relationship.

Aggregation of plans

If an employer aggregates plans of different types for purposes of satisfying the benefits test (see discussion below), the excluded employee rules apply as if such plans were the same type. Thus, for example, the lowest age and service requirements in any plans are to apply. The lowest age requirement may come from one plan, the shortest waiting period may come from another plan, the lowest hour requirement for part-time status may come from a third plan, etc.

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[9] A technical correction may be needed so that the statute reflects this intent.

Special accident or health plan rules

In general

The Act provides certain rules that relate only to accident or health plans. The rules involve (1) treatment of employees or family members covered under another employer's health plan; (2) treatment of family coverage; (3) the type of coverage subject to the nondiscrimination rules; (4) permissible coordination with other accident or health plans; (5) treatment of State-mandated accident or health benefits and continuation coverage; and (6) treatment of part-time employees.

Other coverage

The Act provides that for purposes of applying the benefits test to accident or health plans, an employer may elect to disregard any employee if the employee and the employee's spouse and dependents (if any) are covered by a health plan that provides core benefits and that is maintained by another employer of the employee, spouse, or dependents. Also, in testing employee coverage only under the benefits test (see discussion in this section), an employee may be disregarded if such employee is covered by a health plan that provides core benefits and that is maintained by another employer of the employee, spouse, or dependents. An employee may not, however, be disregarded in applying the benefits test to any other type of plan, even if accident and health plans are aggregated with such other type of plan for purposes of applying the benefits test to such other type of plan. (See discussion below.)

An election to disregard employees under the rules described above is to be made under rules prescribed by the Secretary. In general, an election is to apply to all employees of the employer who could be disregarded. However, if the employer is applying the nondiscrimination rules on a separate line of business or operating unit basis, the election may be made separately with respect to any separate line of business or operating unit.

For purposes of these rules, the term "core benefits" generally has the same meaning as for purposes of determining the excluded employees (see "Excluded employees" above) except to the extent provided by the Secretary. For example, the Secretary is to except from the definition of core benefits for this purpose, any benefits attributable to a salary reduction medical reimbursement plan or a low-level nonelective medical reimbursement plan. In addition, in no event may disability coverage be considered a core benefit.

Family coverage

Under the Act, family coverage (i.e., coverage of an employee's family which under the Act is considered separate from coverage of the employee) may be considered to be available or provided to an employee despite the fact that the employee does not have a family.[10] The purpose of this rule is to relieve employers from the burden of determining which employees have families.

Congress also recognized, however, that this rule alone could produce inappropriate results in certain very limited circumstances and intended that the nondiscriminatory provision test (see discussion above) be applied to prevent such results. Thus, if, under the facts and circumstances, it is clear that the employer is, by using the above rule—allowing family coverage to be considered to be available or provided to an employee who does not have a family—evading the other nondiscrimination tests, the nondiscriminatory provision test is not to be considered satisfied with respect to the relevant plan or plans.

For example, assume that an employer had 2 highly compensated employees and 8 nonhighly compensated employees, none of whom had families. The employer provided $3,000 of employee coverage to each of the 2 highly compensated employees. For the same year, the employer provided family coverage to each of the 8 nonhighly compensated employees the value of which was $3,000 per employee under the Secretary's valuation tables. Because comparable plans may be aggregated for purposes of the alternative 80-percent test, the employer would satisfy such test. This is not the result intended by Congress, since the facts of this case clearly indicate that by using the rule allowing family coverage to be considered to be provided to employees without families the employer is avoiding providing the nonhighly compensated employees truly nondiscriminatory benefits. Thus, the nondiscriminatory provision test would not be considered satisfied with respect to the plan covering the highly compensated employees.

This application of the nondiscriminatory provision test applies not only with respect to evasion of the alternative 80-percent test, but to evasion of any of the tests. For example, the nondiscriminatory provision test would not be considered satisfied with respect to a plan maintained by the employer in the above example for its highly compensated employees if such plan satisfied the 90-percent/50-percent test by virtue of a second plan making family coverage available to the nonhighly compensated employees.

Congress also provided a special rule in recognition of the fact that in certain instances highly compensated employees will have a disproportionately high percentage of families. In such situations, if family coverage is available under a contributory plan, highly compensated employees will likely receive a disproportionate amount of the coverage. Thus, Congress permitted employers the option of applying the benefits test separately to family coverage as if the only employees of the employer were those with families. (Since this rule is elective for employers, employers not using the rule are not required to determine which employees have families.)

In addition, an employer may elect to disregard, solely for purposes of testing family coverage separately under the benefits test, employees who have a family all of whom are covered by a health plan that provides core benefits and that is maintained by another employer of the employee, spouse, or dependents. (In effect, the family is disregarded.) However, neither this rule nor the rule regarding separate testing of family coverage applies if all accident and health plans are aggregated with plans of a different type for purposes of applying the benefits test to such other plans.

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[10] A technical correction may be needed so that the statute reflects the treatment of family coverage described below.

An election to disregard families under the above rule is to be made under rules similar to those referred to in "Other coverage," above.

In addition, the rule permitting employers to test family coverage separately and, with respect to such family coverage, to take into account only employees with families also applies to the alternative 80-percent test. However, for this purpose, the rule permitting families to be disregarded based on other coverage does not apply.

Special rules for other coverage and family coverage

If an employee or a family is disregarded for purposes of the benefits test, any coverage actually provided to the employee or family is disregarded in determining the average employer-provided benefit, as is the existence of that employee or family. An exception to this rule provides that in no case may a highly compensated employee be disregarded if the coverage provided with respect to the highly compensated employee under all accident and health plans of the employer has a value in excess of 133⅓ percent of the average employer-provided benefit provided with respect to nonhighly compensated employees.[11] If employee and family coverage are tested separately, the same rule applies to each. Thus, with respect to family coverage, for example, the family of a highly compensated employee may not be disregarded if the coverage provided with respect to such family has a value in excess of 133⅓ percent of the average employer-provided benefit provided with respect to families of nonhighly compensated employees.

The rules described above allowing certain employees or families to be disregarded apply only to the benefits test. Thus, for example, the fact that an employee has other core health coverage does not mean such employee may be disregarded for purposes of the eligibility tests or the alternative 80-percent test.

The Secretary is to prescribe rules, consistent with the rules described above, for the treatment of an employee who has a spouse or dependent employed by the same employer.

Statements regarding family members and other coverage

An employer who elects the optional rules described above is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether individuals have spouses, dependents, or core health coverage from another employer. Congress intended that an employer who elects the application of these optional rules may not treat a nonhighly compensated employee as having other coverage (of the employee or the employee's family), as not having a family, or both unless the employer has a statement to that effect that includes, with respect to the other coverage, the name of the insurer and the employer providing the coverage. In the case of a highly compensated employee, Congress intended that the opposite presumptions are to apply. Thus, a highly compensated employee may not be treated as not having other coverage (of the employee or the employee's family), as having a family, or both, unless the employer has a sworn statement to that effect.

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[11] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H.Con.Res. 395 which passed the House and Senate in the 99th Congress.

The statements required for purposes of these special rules are to be collected annually on forms provided by the Internal Revenue Service that indicate whether other coverage was provided (or is expected to be provided) for the entire plan year and whether the employee has a family. The statements need not be notarized.

Congress also permitted employers to secure sworn statements from a statistically valid sample of all employees and to use the results of the sample to project the facts regarding the entire workforce. Such a sampling is required to be performed by an independent third party in accordance with rules prescribed by the Secretary. If this sampling rule is used, the same rules described above apply, including the presumptions and the annual collection on IRS forms. In addition, the report by the third party is to be attached to the employer's return and is to include such facts regarding the sampling as are required by the Secretary.

For cases in which an employer avails itself of this sampling rule, the Secretary is to prescribe rules for disregarding actual coverage provided. For example, if the sampling shows that 10 percent of a group of nonexcludable employees has core health benefits from another employer, the Secretary could require that the 10 percent of the nonexcludable employees with the lowest health benefits from the employer (including those with no health benefits) are to be disregarded, subject to the 133⅓-percent rule described above.

Coverage subject to the nondiscrimination rules

Under the Act, disability coverage attributable to employer contributions (including elective contributions) is subject to the nondiscrimination rules to the extent that benefits provided under such coverage are excludable from income (sec. 105(b) or (c)); no other disability coverage is subject to the rules. Disability coverage subject to the rules is tested for discrimination generally in the same manner in which health coverage is tested.

All plans providing medical care (as defined under sec. 213) are health plans and thus subject to the nondiscrimination rules, including, for example, plans providing ancillary benefits such as dental or vision coverage and physical examination plans.

With respect to accident or health plans, it is the value of the coverage provided, not the contributions, that is subject to the nondiscrimination rules. (Correspondingly, the Act modified the exclusion section to apply to the value of the coverage, rather than to the contributions under the plan.)

Coordination with other plans

Under the Act, an accident or health plan may be integrated (in a manner that does not favor highly compensated employees) with accident or health benefits provided under Federal, State, or foreign law, or under any other accident or health plan, provided sucl integration is otherwise permissible.

State-mandated benefits and continuation coverage

The Act authorizes the Secretary, in applying the nondiscrimination rules to accident or health plans, to disregard State-mandated benefits under certain circumstances. For example, in comparing the benefits of employees in one State to the benefits of employees in another State, the Secretary may disregard benefits that are mandated in one of the States but are not mandated in the other.

Congress intended, however, that only ancillary benefits may be disregarded, rather than core benefits. For example, if a State mandates an HMO option, Congress did not intend that the value of coverage under an HMO may be disregarded.

Congress further intended that, under rules prescribed by the Secretary, certain benefits provided in connection with "continuation coverage" are to be disregarded in applying the nondiscrimination rules. For example, if an employer requires that a qualified beneficiary who elects continuing health coverage pay, on an after-tax basis, the maximum amount permitted under the rules of section 162(k), any excess of the value of employer-provided coverage over the amount charged is to be disregarded in applying the nondiscrimination rules.

Part-time employee rule

In applying the benefits test and the 50-percent component of the 90-percent/50-percent test to accident or health plans, the Act provides that an employer may elect to adjust the benefits provided to certain employees. With respect to an employee who normally works less than 22-1/2 hours per week, an employer may deem benefits provided (or available in the case of the 90-percent/50-percent test) to have a value equal to up to double the actual value of coverage provided (or available). With respect to an employee who normally works less than 30 hours per week, an employer may deem benefits provided (or available) to have a value equal to up to 1-1/3 times the actual value.

If this part-time employee rule is used, it is to be used on a uniform, nondiscriminatory basis for all employees. However, the rule may not be applied for any purpose in a plan year unless during such year more than 50 percent of the nonexcludable employees (determined without regard to plan provisions) normally work more than 30 hours per week. In addition, the multiplication of the benefit under this rule does not apply to elective contributions.

Aggregation of plans for the benefits test

In applying the benefits test to a plan other than an accident or health plan, the Act provides that the employer may aggregate different types of statutory employee benefit plans. Thus, for example, an employer may aggregate benefits provided under all group-term life insurance plans and all qualified group legal services plans (if the employer elects to treat such plans as statutory employee benefit plans) in order to satisfy the benefits tests with respect to all such plans. In addition, an employer may aggregate all accident and health plans with plans providing benefits excludable under 1 or more other Code sections for purposes of satisfying the benefits test with respect to plans other than accident or health plans.

In no case, however, may an employer aggregate with other plans some but not all of the plans providing benefits excludable under a Code section. Thus, an employer may not, for example, aggregate some but not all of its group-term life insurance plans with all of its qualified group legal services plans.

When plans excludable under different Code sections are aggregated for purposes of the benefits test, the definition of excluded employees (for purposes of determining the average employer-provided benefit) is to be made as if the plan benefits were excludable under the same Code section. Thus, the lowest age and service requirements from any plans apply (see "Excluded employees" above), and if members of a collective bargaining unit are not excluded for one aggregated plan, they are not excluded for the group of plans. Thus, in determining the average employer-provided benefit, the denominator is all nonexcludable employees, determined generally under the employer's most expansive definitions of such term.

Time for testing

Under the Act, the nondiscrimination rules are to be applied on the basis of the benefits available or provided during the entire year. An example will illustrate how this rule applies for purposes of the benefits test. Assume employee A becomes nonexcludable on July 1 and on that day A is covered under a health plan that provides coverage that on an annual basis has a value of $1,000. The employer's plan year is the calendar year, so for that plan year, A only receives $500 worth of benefits. That $500 goes in the numerator in determining the average employer-provided benefit. However, because A was only taken into account for half the year, A is only counted as half an employee in the denominator.

Congress also provided, for accident or health plans and group-term life insurance plans, a rule of convenience to ease the administrative burden on employers. Under this rule of convenience, an employer may, for purposes of applying the benefits test to active employees, treat employees who separate from service during the last 3 months (or a shorter period elected by the employer) of the plan year as continuing to work and receive benefits for the remainder of the plan year. For employees who separate from service earlier in the plan year, an employer may treat such employees as continuing to work and receive benefits through the end of the month in which they separate. (An employer may elect to apply this rule to periods of less than 31 days specified by the plan; for example, an employer may elect to treat employees as continuing to work and receive benefits through the end of the 4-week period in which they separate.) The effect of these rules is that employers will not have to use the exact day that employees separate in calculating the average employer-provided benefit. Instead, an employer may deem employees to have separated only on the last day of a month (or a shorter period) and in the case of employees separating in the last quarter, on the last day of the plan year.

For purposes of this rule of convenience, employees are considered to receive after separation whatever benefit they had been receiving prior to separation, provided such benefit had been provided for at least 90 days prior to separation. If there had been a change in the benefit during such 90-day period, then the benefit deemed provided during the period of separation is the average benefit provided to the employee during the period beginning on the date in the plan year on which the employee first had to be taken into account for purposes of the nondiscrimination rules and ending on the date of separation from service.

The rule illustrated by the example treating A as only half an employee for purposes of the benefits test and the rule of convenience described above do not apply to group-term life insurance plans with respect to which the employer adjusts the value of the benefit provided based on the employee's compensation or otherwise takes compensation into account. See the discussion above for a description of the adjustment.

The rule of convenience described above also applies to the alternative 80-percent test, the 90-percent/50-percent test, the 50-percent test, and the comparability rules, except that for purposes of the eligibility tests, employees who have separated from service are deemed to have available to them after separation the benefits available prior to separation. For purposes of determining the benefits available prior to separation, the same rules applicable for the benefits test apply. Other than this one difference, the rule of convenience applies in the same manner. Thus, in determining whether the tests listed above are satisfied, an employer is required to examine the entire year, but may use the rule of convenience to reduce substantially the administrative burden. For example, assume that an employee (A) who was not excludable on the first day of the plan year separated from service during the sixth month of the plan year. A may be considered to be employed through the end of the sixth month and have available or provided benefits determined under the rule of convenience described above. During the second 6 months, A is not an active employee for purposes of applying the tests.

Of course, the rule of convenience under which employees are deemed to receive or have available to them benefits after separation from service does not apply in testing benefits actually received by or available to former employees. (See discussion below.)

As is true with respect to the nondiscrimination rules applicable to qualified retirement plans, the fact that a failure to meet any of the nondiscrimination rules was attributable to unforeseen circumstances does not affect the application of the rules.

Congress also provided an additional rule of convenience for employers that do not require any initial period of service for participation in a statutory employee benefit plan. Under this second rule of convenience, an employer may, for purposes of the 90-percent/50-percent test and the benefits test, disregard benefits available or provided to an employee during the interval between the employee's commencement of employment and the first day of the first calendar month (or the first day of a period of less than 31 days specified by the plan, such as a 4-week period) following such commencement. (This rule does not apply to an employee who commences employment on the first day of a calendar month (or of the shorter period).) However, benefits available or provided during such interval that relate to any other period may not be disregarded. For example, if an employer pays for a year's worth of dependent care or provides an annual physical examination, only a proportionate part of the value of such benefit may be disregarded. This second rule of convenience applies to all statutory employee benefit plans. If an employer uses this rule of convenience, it is required to do so with respect to all employees.

Former employees

The Act provides that, except to the extent provided by the Secretary, rules similar to the nondiscrimination rules applicable to active employees are to be applied separately to former employees. In applying the rules to former employees, the Secretary is to provide certain special provisions. Under such provisions, employers generally may restrict the class of former employees to be tested to those who have retired on or after a reasonable retirement age, or to those who have separated from service due to disability. In addition, employers generally may limit the class further to employees who have, for example, retired within a certain number of years. Finally, in testing whatever class of employees is chosen, employers may make reasonable assumptions regarding mortality, so that they do not have to determine those former employees not covered by a plan who are still alive.

Benefits other than life and health

In general

As noted above, the new nondiscrimination rules apply on a mandatory basis only to accident or health plans and group-term life insurance plans.

With respect to dependent care assistance programs, the prior-law eligibility standards continue to apply, but the Act adds a special benefits test described below. The prior-law nondiscrimination rules apply to qualified tuition reduction programs, qualified group legal services plans, educational assistance programs, employee benefit programs providing no-additional-cost services, qualified employee discounts, or employer-operated eating facilities (sec. 132), and welfare benefit funds.

The reason that the new nondiscrimination rules are not mandatorily applicable to qualified group legal services plans and educational assistance programs is that these types of plans generally are scheduled to expire prior to the effective date of the new nondiscrimination rules. Congress anticipates, however, that if the qualified group legal services plans and educational assistance programs are extended to periods after the effective date of the new nondiscrimination rules, such nondiscrimination rules will be applied on a mandatory basis.

Also, as noted above, the Act permits employers to elect to treat qualified group legal services plans, educational assistance programs, and/or dependent care assistance programs as statutory employee benefit plans, and to apply the new nondiscrimination rules to them in lieu of the otherwise applicable nondiscrimination rules (though not in lieu of the applicable concentration tests (secs. 120(c)(3), 127(b)(3), and 129(d)(4)). Such an election enables an employer to use these types of plans for purposes of satisfying the benefits test. (See the description in "Benefits test" above.)

Although the new nondiscrimination rules do not mandatorily apply to plans other than accident or health plans and group-term life insurance plans, the Act does provide certain amendments described below affecting other employee benefits.

Definitions

The following definitions applicable to statutory employee benefit plans also are applied to qualified tuition reduction programs, qualified group legal services plans, cafeteria plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits (sec. 132), and welfare benefit funds: (1) highly compensated employees; (2) compensation (including the limitation on the amount that can be taken into account) with respect to those plans for which compensation is relevant; (3) excluded employees; and (4) employer (including application of the employee leasing rules). These new definitions are discussed more fully in this Part, above, except for the "compensation" definition and limitation, which are discussed in Part B.1. and Part D., above.

The only plans for which compensation is relevant, other than group-term life insurance plans (which are discussed above), are plans providing life insurance, disability, severance pay, or supplemental unemployment compensation through a welfare benefit fund.

With respect to nonemployees participating in a plan that is part of a welfare benefit fund, the Secretary is to prescribe appropriate rules for determining which, if any, of such nonemployees are to be considered highly compensated employees.

Dependent care assistance programs

As noted, a special benefits test applies to dependent care assistance programs that are not treated as statutory employee benefit plans. Under this special rule, the same benefits test applicable to statutory employee benefit plans applies,[12] with two modifications.

First, the average employer-provided benefit received by nonhighly compensated employees is required to be at least 55 percent (as opposed to 75 percent) of the average employer-provided benefit received by highly compensated employees.

Second, for purposes of applying the benefits test to salary reduction amounts, employees with compensation (as defined in sec. 414(q)(7))[13] below $25,000 may be[14] disregarded. If an employer provides dependent care assistance both through salary reduction and otherwise, the treatment of the employees with compensation below $25,000 is to be determined under rules prescribed by the Secretary.

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[12] This benefits test was intended to apply notwithstanding the provision providing that utilization rates cannot cause a dependent care assistance program to fail to qualify. (Sec. 129(e)(6).) A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H.Con.Res. 395 which passed the House and Senate in the 99th Congress.

[13] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the version of H.Con.Res. 395 which passed the House and Senate in the 99th Congress.

[14] A technical correction may be needed so that the statute reflects the intent that an employer may elect whether to disregard employees with compensation below $25,000.

Cafeteria plans

The Act retains the prior-law eligibility test for cafeteria plans. The Act deletes the special cafeteria plan benefits tests, although the concentration test is retained. Thus, each type of benefit available or provided under a cafeteria plan is subject to its own applicable nondiscrimination rules and to any applicable concentration test. For example, group-term life insurance benefits under a cafeteria plan are required to satisfy the nondiscrimination rules applicable to group-term life insurance plans outside a cafeteria plan. As discussed above, certain aggregation of plans excludable under different Code sections is permissible for purposes of the benefits test applicable to statutory employee benefit plans.

The Act also modifies the definition of a cafeteria plan to include a plan under which an employee may only choose among qualified benefits and may not choose cash or a taxable benefit. In addition, the Act creates a new exception to the general rule that the term "cafeteria plan" does not include any plan that provides for deferred compensation. The exception applies to certain post-retirement life insurance provided under a plan maintained by an educational organization. See Part F.6., below.

Under the Act, the definition of a qualified benefit is modified so that a benefit will not fail to be a qualified benefit solely because it is includible in an employee's income under section 89.[15] Thus, for example, if a portion of the health benefits provided under a plan are discriminatory under section 89 and thus includible in income, that alone will not cause the plan to fail to be a cafeteria plan.

The Act provides that if a cafeteria plan does not satisfy the cafeteria plan eligibility or concentration test, the benefits under the plan are taxable to highly compensated employees or key employees, respectively.[16]

The Act allows employers to limit the elections of highly compensated employees to the extent necessary to comply with the applicable nondiscrimination rules. However, the limitations are to be applied, under rules prescribed by the Secretary, in the manner described above for allocating the discriminatory excess among highly compensated employees.

Reporting

The Act also amends the rules regarding reporting of employee benefits and extends those rules to additional benefits. These rules are discussed below.

Qualification requirements

In general

In addition to imposing new nondiscrimination rules, the Act also prescribes certain basic standards that any employee benefit plan must satisfy in order to preserve the applicable exclusion for employees.

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[15] A technical correction may be needed so that the statute reflects this intent.

[16] A technical correction may be needed so that the statute reflects this intent.

Under the Act, except to the extent provided in regulations, the gross income of any employee, whether or not highly compensated, includes such employee's employer-provided benefit under an employee benefit plan, unless (1) the plan is in writing; (2) the employees' rights under the plan are legally enforceable; (3) employees are provided reasonable notification of benefits available under the plan; (4) the plan is maintained for the exclusive benefit of the employees; and (5) the employer established the plan with the intention of maintaining it indefinitely.

These rules apply to statutory employee benefit plans, qualified tuition reduction programs, qualified group legal services plans, cafeteria plans, educational assistance programs, dependent care assistance programs, fringe benefit programs providing no-additional-cost services, qualified employee discounts, or employer-operated eating facilities (sec. 132), and plans providing benefits through a welfare benefit fund. With respect to dependent care assistance programs, the required notification is to include a description of the dependent care credit (sec. 21) and the circumstances under which the credit is more advantageous than the exclusion.

With respect to the requirement that a statutory employee benefit plan be legally enforceable, Congress intended that a plan will generally not be considered legally enforceable if it is discretionary with the employer. For example, if a plan of the employer provides that medical expenses will be reimbursed at the employer's discretion, the plan is not legally enforceable, because the employees have no right to compel payment of benefits. A plan will not fail to satisfy the legally enforceable requirement merely because the employer has the right to terminate the plan with respect to claims not yet incurred. If, however, the employer maintains the right to terminate the plan with respect to incurred claims, those claims would not be considered legally enforceable, and payment of the claims would not be excludable. Of course, termination in some circumstances could violate the permanency requirement.

With respect to the requirement that a plan be maintained for the exclusive benefit of an employer's employees, Congress did not intend that a plan would fail to satisfy this requirement merely because benefits are provided to nonemployees whose receipt of the benefits is excludable under the Code section that excludes the same benefits when provided to employees. For example, under section 132(f)(3), use of air transportation by a parent of an employee is treated as use by the employee for purposes of determining the excludability of the air transportation. In such a situation, excludable use of air transportation by a parent of an employee under an employer's plan would not cause the plan to fail to satisfy the requirement that it be maintained for the exclusive benefit of the employer's employees.

In addition, Congress did not intend that a plan fail to satisfy the exclusive benefit rule merely because benefits are provided under the plan to nonemployees on a basis that is not tax-favored. For example, if an airline furnishes nonexcludable air transportation to its directors under the same plan maintained for employees, the plan will not fail to satisfy the exclusive benefit rule merely because taxable benefits are provided to nonemployees.

Employer-provided benefit

Notwithstanding the valuation rules for purposes of the nondiscrimination rules, if any plan fails to satisfy the qualification requirements described above, an employee's employer-provided benefit is defined as the value of the benefits provided to or on behalf of such employee, to the extent attributable to contributions made by the employer (including elective contributions). Thus, even in the case of insurance-type plans, the amount includible in an employee's income is the value of the benefits, not the coverage.

For example, in the case of a health plan failing the qualification requirements, the services provided and reimbursements made are includible in income. In addition, such amount is includible in an employee's gross income in the taxable year in which such benefits are received.

Employer sanction

The employer-level sanction applicable to a failure to report discriminatory benefits in a timely manner also applies to a failure to report income attributable to a violation of the qualification requirements. However, this sanction applies to the value of benefits in all such cases, rather than to the value of coverage. (The sanction applicable to the nondiscrimination rules applies to the value of coverage with respect to insurance-type benefits.)

Reporting requirements

The Act expanded the prior-law requirement that the employers that maintain cafeteria plans, educational assistance programs, and qualified group legal services plans file information returns in accordance with regulations (sec. 6039D). Under the Act, this requirement also applies to statutory employee benefit plans and dependent care assistance programs.

The Act also modified the reporting requirements by requiring that all employers maintaining a plan subject to the requirements report the number of highly compensated employees (1) of the employer, (2) eligible to participate in the plan, and (3) participating in the plan. Also, the Act clarifies that the requirement that certain employers file an additional return only applies to a representative sample of employers.

In addition, if benefits provided to an employee are includible in such employee's income due to a violation of the new nondiscrimination rules or of the qualification requirements, the employer is required to include such amounts separately on an employee's Form W-2. For a description of the penalty for a failure to include such an amount, see discussion above.

Effective Dates

In general

Under the Act, the general effective date is plan years beginning after the later of (1) December 31, 1987, or (2) the earlier of December 31, 1988, or the date 3 months following the issuance of Treasury regulations.

Collective bargaining agreements

A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Highly compensated employee definition

For purposes of the sanction applicable to a violation of the rules regarding continuation of health care (sec. 106), the new definition of highly compensated employee applies to years beginning after December 31, 1986. With respect to qualified tuition reduction programs, qualified group legal services plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits (sec. 132), and welfare benefit funds, the new definition applies to years beginning after 1987. The new definition applies to statutory employee benefit plans and cafeteria plans when the new rules described above are generally effective with respect to such plans.

Aggregation of employers for continuation of health care

The provisions aggregating related employers and applying the employee leasing rules for purposes of the continuation of health care rules apply to years beginning after December 31, 1986.[17]

Group-term life insurance plans

The Act contains an exception to the new rules for certain group-term life insurance plans. In the case of a plan described in section 223(d)(2) of the Tax Reform Act of 1984, such plan is to be treated as meeting the requirements of the new nondiscrimination rules with respect to individuals described in section 223(d)(2) of the Act. (Of course, an individual to whom section 223(d)(2)(A) does not apply because of section 223(d)(2)(B) is not considered to be described in section 223(d)(2).) In addition, an employer may elect to exclude such individuals in applying the new nondiscrimination rules.

At the election of the employer, the new rules described in this section (including the nondiscrimination rules, qualification rules, and cafeteria plan rules) are to apply to certain group-term life insurance plans in plan years beginning after October 22, 1986.[18] The plans for which this election is available are those that are maintained by educational institutions (within the meaning of sec. 170(b)(1)(A)(ii)) and that are described in "Exclusion for Post-Retirement Group-Term Life Insurance Under a Cafeteria Plan" below.

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[17] A technical correction may be needed so that the statute reflects this intent. A correction that reflected part of this intent was included in the versions of H.Con.Res. 395 which passed the House and Senate in the 99th Congress.

[18] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H.Con. Res. 395 which passed the House and Senate in the 99th Congress.

Church plans

In addition, the Act provides a delayed effective date for church plans. Such plans are not required to comply with the new nondiscrimination rules until years beginning after December 31, 1988.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $72 million in 1988, $128 million in 1989, $140 million in 1990, and $154 million in 1991.

2. Deductibility of health insurance costs of self-employed individuals (sec. 1161 of the Act and sec. 162 of the Code)[19]

Prior Law

Under prior and present law, an employer's contribution to a plan providing accident or health benefits is excludable from an employee's income (sec. 106). No equivalent exclusion was provided, under prior law, for self-employed individuals (sole proprietors or partners).

Benefits actually paid to an employee under an accident or health plan generally are includible in the employee's gross income to the extent attributable to employer contributions (sec. 105(a)). Reimbursements for costs incurred for medical expenses (within the meaning of sec. 213) and disability benefit payments that compensate for permanent injury and are computed without reference to the period of absence from work are excluded from gross income (secs. 105(b) and (c)).

Individuals who itemized deductions were permitted, under prior law, to deduct amounts paid during the taxable year, if not reimbursed by insurance or otherwise, for medical care of the taxpayer and of the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeded five percent of adjusted gross income (sec. 213).

Reasons for Change

Congress believed the prior-law rules relating to the exclusion from income for benefits under employer accident or health plans created unfair distinctions between self-employed individuals (the owners of unincorporated businesses) and the owners of corporations. The ability to exclude health benefits of an owner to the extent provided by a corporate employer created tax incentives for incorporation that Congress believed led to inefficient tax-driven decision making.

More importantly, Congress was aware that access to employer health plans is lowest with small employers (particularly with small, self-employed employers). The need for adequate health coverage is so important that Congress believed it was essential to encourage a narrowing of the gap in health coverage. Congress concluded that a partial temporary exclusion for health plans maintained by self-employed individuals would accomplish this goal.

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[19] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1261; S.Rep. 99-313, pp. 665-667; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 538-539 (Conference Report).

However, Congress also believed this exclusion for the self-employed would not be justified unless nondiscriminatory health insurance coverage is also extended to the employees of an unincorporated employer. To facilitate implementation of these nondiscrimination rules, Congress found it desirable to direct the Secretary to provide guidance for small employers.

Explanation of Provision

The Act provides a deduction for 25 percent of the amounts paid for health insurance for a taxable year on behalf of a self-employed individual and the individual's spouse and dependents. This deduction is allowable in calculating adjusted gross income. A self-employed individual means an individual who has earned income for the taxable year (sec. 401(c)(1)). However, under the Act, no deduction is allowable to the extent the deduction exceeds the self-employed individual's earned income for the taxable year. In addition, no deduction is allowable for any taxable year for which the self-employed individual is eligible to participate (on a subsidized basis) in a health plan of an employer of the self-employed individual or of such individual's spouse.

In addition, the deduction is not allowable unless the nondiscrimination requirements (as modified by the Act) applicable to accident or health plans are satisfied with respect to each such plan tested as though all coverage for which a 25-percent deduction is allowable under this section were employer-provided.

Under the Act, the amount allowable as a deduction for health coverage for a self-employed individual is not also taken into account for purposes of determining the amount of any medical deduction to which the self-employed individual is entitled. Thus, such amounts deductible under this provision are not treated as medical expenses of the individual for purposes of determining whether the threshold for the itemized medical expense deduction (sec. 213(a)) is met.

Further, the Act provides that the amount deductible under this provision is not taken into account in computing net earnings from self-employment (sec. 1402(a)). Therefore, the amounts deductible under this provision do not reduce the income base for the self-employed individual's social security tax.[20]

The Act directs the Treasury to provide guidance to self-employed individuals to whom this deduction applies with respect to the nondiscrimination requirements applicable to accident or health plans.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986. The provision does not apply to any taxable year beginning after December 31, 1989.

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[20] A technical correction may be needed so that the statute reflects this intent.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $141 million in 1987, $205 million in 1988, $227 million in 1989, and $71 million in 1990.

3. Exclusions for educational assistance programs, qualified group legal services plans, and dependent care assistance programs (secs. 1162 and 1163 of the Act and secs. 120, 127, and 129 of the Code)[21]

Prior Law

Educational assistance

Under prior and present law, an employee is required to include in income for income and employment tax purposes the value of educational assistance provided by an employer to the employee, unless the cost of such assistance qualifies as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible employee business expenses if the education (1) maintains or improves skills required for the employee's job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of employment. Under prior law, an employee's gross income for income and employment tax purposes did not include amounts paid or expenses incurred by the employer for educational assistance provided to the employee if such amounts were paid or such expenses were incurred pursuant to an educational assistance program that meets certain requirements (Code sec. 127).

Under prior law, the maximum amount of educational assistance benefits that an employee could receive tax-free during any taxable year was limited to $5,000; thus, the excess benefits over this amount were subject to income and employment taxes. In the case of an employee who worked for more than one employer, the $5,000 cap applied to the aggregate amount of educational assistance benefits received from all employers.

The exclusion for educational assistance benefits expired for taxable years beginning after December 31, 1985.

Group legal services

Under prior law, amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) were excluded from an employee's gross income for income and employment tax purposes (sec. 120). The exclusion also applied to any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). In order to be a qualified plan under which employees were entitled to tax-free benefits, a group legal services plan was required to fulfill several requirements. An employer maintaining a group legal services plan was required to file an information return with respect to the program at the time and in the manner required by Treasury regulations.

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[21] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1161; H. Rep. 99-426, pp. 779-781; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1262; S.Rep. 99-313, pp. 667-670; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 539-542 (Conference Report).

The exclusion for group legal services benefits expired for taxable years ending after December 31, 1985.

In addition, under prior law, an organization, the exclusive function of which was to provide legal services or indemnification against costs of legal services as part of a qualified group legal services plan, was entitled to tax-exempt status (sec. 501(c)(20)). The tax exemption for such an organization expired for years ending after December 31, 1985.

Dependent care assistance

Under prior and present law, amounts paid or incurred by an employer for dependent care assistance provided to an employee through a dependent care assistance program are excludable from gross income (sec. 129). The amount excludable was limited, under prior law, to the employee's earned income for the year or, in the case of married couples, the lesser of the employee's earned income and the earned income of the employee's spouse. A dependent care assistance program must be a written plan for the exclusive benefit of employees, must not discriminate in favor of certain employees and must meet certain other requirements.

Reasons for Change

Educational assistance and group legal services

The exclusions for educational assistance and group legal services were originally enacted in 1978 for a temporary period in order to provide Congress with an opportunity to evaluate the use and effectiveness of the exclusions. However, the absence of any information reporting prior to 1985 made it difficult to obtain information concerning the operation of the exclusions.

Congress recognized that the Treasury Department was conducting a comprehensive examination of the effect of the exclusions for educational assistance and group legal services on the income, wage, and benefit bases. Congress believed that it was appropriate to extend the educational assistance and group legal services exclusion for an additional 2 years to permit Treasury to complete its evaluation of the effect of these exclusions based on the information reports that employers are now required to file.

Dependent care assistance

Congress was concerned about the relationship under prior law of the exclusion for employer-provided dependent care assistance and the child care credit. Congress recognized that the prior-law exclusion was more valuable to higher-income taxpayers than the child care credit. Moreover, Congress believed that it was inequitable to provide an unlimited exclusion to individuals whose employers provide dependent care assistance, but a limited tax credit to individuals who were required to pay their own child care expenses.

Consequently, Congress concluded that it was desirable to place a dollar limit on the annual exclusion for employer-provided dependent care assistance benefits to coordinate the exclusion with the tax incentives provided to individuals through the child care credit.

Explanation of Provisions

Educational assistance

The Act retroactively extends the educational assistance exclusion for 2 years. In addition, the Act increases the cap on annual excludable educational assistance benefits to $5,250 from $5,000.

The exclusion is scheduled to expire for taxable years beginning after December 31, 1987.

Group legal services

The Act retroactively extends the group legal services exclusion for 2 years. This provision also extends the tax-exempt status of group legal services organizations (sec. 501(c)(20)). The exclusion is scheduled to expire for taxable years ending after December 31, 1987.

The Act provides a transition rule for group legal services benefits provided under a cafeteria plan. Under this transition rule, an employee will be permitted to revoke an election to take cash or a qualified benefit other than group legal services and to make a new election to take group legal services instead. Such revocation and new election is required to be made no later than 60 days after October 22, 1986, and may relate to any period after December 31, 1985. This transition rule is limited to cafeteria plans that, prior to August 16, 1986, did not allow employees to elect group legal services benefits with respect to a period after December 31, 1985.

Dependent care assistance

The Act limits the exclusion for dependent care assistance to $5,000 a year ($2,500 for a married individual filing separately).

In addition, the Act clarifies the amount of dependent care assistance provided with respect to any employee in the case of an onsite facility maintained by the employer. In the case of an onsite facility, the amount excluded with respect to any dependent is to be based on utilization of the facility by a dependent of the employee and the value of the services provided.

Effective Dates

The provision relating to educational assistance programs is effective for taxable years beginning after December 31, 1985.

The provision relating to group legal services is effective for taxable years ending after December 31, 1985.

The modifications relating to dependent care assistance apply to taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $408 million in 1987, $71 million in 1988, and to increase fiscal year budget receipts by less than $5 million in 1989, 1990, and 1991.

4. Treatment of certain full-time life insurance salespersons (sec. 1166 of the Act and sec. 7701(a)(20) of the Code)[22]

Prior Law

Under a cafeteria plan, an employee is offered a choice between cash and one or more employee benefits. If certain requirements are met, then the mere availability of cash or certain permitted taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes.

Under prior and present law, a full-time life insurance salesperson is treated as an employee for purposes of eligibility for certain enumerated employee benefit exclusions (sec. 7701(a)(20)). However, although such a salesperson was eligible to receive certain excludable employee benefits that may be provided under a cafeteria plan under prior law, the salesperson was not treated as an employee for purposes of the cafeteria plan provisions.

Reasons for Change

Congress believed it was inconsistent to treat full-time life insurance salespersons as employees for certain employee benefit exclusions, yet limit the ability of such salespersons to elect to receive the same benefits under a cafeteria plan.

Explanation of Provision

The Act permits a full-time life insurance salesperson to be treated as an employee for purposes of the cafeteria plan provisions with respect to benefits that the salesperson is otherwise permitted to exclude from income.[23]

Effective Date

The provision applies for years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

5. Exclusion of cafeteria plan elective contributions from wages for purposes of employment taxes (sec. 1151(g) of the Act, sec. 209(e) of the Social Security Act, and secs. 3121(a)(5) and 3306(b)(5) of the Code)[24]

Prior Law

Under prior and present law, no amount is included in the gross income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, the participant may choose among the benefits of the plan. However, the fact that remuneration is not subject to income tax withholding does not necessarily mean that such remuneration is not subject to tax under the Federal Insurance Contributions Act (FICA) or under the Federal Unemployment Tax Act (FUTA). Both the FICA and FUTA taxes apply to all remuneration for employment, with certain exceptions. There was no provision under prior law with respect to either the FICA or the FUTA that would render inapplicable the principles of constructive receipt of benefits under a cafeteria plan or any other flexible choice plan.

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[22] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1162; H.Rep. 99-426, pp. 781-782; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 542 (Conference Report).

[23] A technical correction may be needed so that the statute reflects this intent.

[24] For legislative background of the provision, see: H.Rep. 99-841, Vol. II (September 18, 1986), pp. 542-543 (Conference Report).

Reasons for Change

Congress found it appropriate to clarify the employment tax status of benefits provided under a cafeteria plan.

Explanation of Provision

The Act clarifies that the cafeteria plan exception from the principles of constructive receipt also applies for purposes of the FICA and FUTA taxes. This clarification does not apply to elective contributions under a qualified cash or deferred arrangement that is part of a cafeteria plan.

Effective Date

The provision is effective with respect to years beginning before, on, or after October 22, 1986.

Revenue Effect

The provision is estimated to have no effect on fiscal year budget receipts.

6. Exclusion for post-retirement group-term life insurance under a cafeteria plan (sec. 1151(d) of the Act and sec. 125(c)(2)(C) of the Code)[25]

Prior Law

Under prior and present law, the cost of permanent benefits under a life insurance policy provided by an employer to an employee is includible in income. In general, a permanent benefit is a benefit with an economic value extending beyond one policy year, such as a paid-up policy for future years.

No amount is includible in the gross income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, the participant may choose among the benefits. Except with respect to elective contributions under a qualified cash or deferred arrangement, the term "cafeteria plan" does not include any plan that provides for deferred compensation.

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[25] For legislative background of the provision, see: H.Rep. 99-841, Vol. II (September 18, 1986), p. 543 (Conference Report).

Reasons for Change

Congress believed that a limited exception to the definition of group-term life insurance and to the deferred compensation rule for cafeteria plans should be provided in the case of nondiscriminatory programs maintained by educational institutions.

Explanation of Provision

As under prior law, the term "cafeteria plan" does not include any plan that provides for deferred compensation, except for a qualified cash and deferred arrangement (as defined in sec. 401(k)(2)). However, new section 125(c)(2)(C) provides an additional exception from the prohibition against deferred compensation for certain post-retirement life insurance for cafeteria plans maintained by educational organizations described in section 170(b)(1)(A)(ii).

Specifically, the prohibition against deferred compensation within a cafeteria plan does not apply to a plan of an educational organization to the extent of amounts that a covered employee may elect to have the employer pay as contributions for post-retirement group life insurance if (1) all contributions for such insurance are to be made before retirement, and (2) such life insurance does not have a cash surrender value at any time. The provision also provides that, for purposes of section 79, any such life insurance is to be treated as group-term life insurance.

Under this provision, Congress intended to allow employees of educational organizations to pre-fund post-retirement life insurance coverage on an individualized basis. Although the insurance coverage might be offered on a group basis to the employees of the educational organization through the cafeteria plan, amounts paid for each electing employee can be credited to individual employee accounts so that the post-retirement life insurance coverage will be fully paid up upon retirement. Under such a plan, the right to the post-retirement life insurance coverage may even vest upon payment of amounts for the electing employee (that is, prior to retirement). However, apart from the paid-up character of the post-retirement coverage, the employee may not have the right to a cash surrender value at any time.

Although the post-retirement life insurance coverage may be guaranteed by a commercial insurer, the employee receives only current life insurance protection after retirement because the employee has no right to a cash surrender value. This guarantee of current life insurance protection under a paid-up insurance policy is similar to that which a retired employee could receive from an actuarially funded group-term life insurance plan. Thus, the provision treats the described post-retirement life insurance benefit as group-term life insurance for purposes of section 79. Accordingly, the value of coverage in excess of $50,000 will be taxable to the retired employee under section 79(c) as it is received annually by the retired employee; section 83 will not apply and the employee will not be taxed on the contributions to fund the post-retirement insurance.

Likewise, the post-retirement life insurance described under section 125(c)(2)(C), as group-term life insurance, will be subject to the nondiscrimination rules under section 89 as well as the rules specifically applicable to cafeteria plans.

Effective Date

The provision is effective for years beginning after the later of (1) December 31, 1987, or (2) 3 months following the issuance of final regulations, but no later than December 31, 1988. An employer may elect to have the provision apply with respect to any plan year beginning after the date of enactment (October 22, 1986), as long as the employer also elects the application of the modifications made by the Act to the employee benefit nondiscrimination rules.[26]

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

7. Tax treatment of qualified campus lodging (sec. 1164 of the Act and sec. 119(d) of the Code)[27]

Prior Law

Under prior and present law, Code section 119(a) excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment.

Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution does not qualify for the section 119(a) exclusion. Therefore, the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes in those cases.[28]

Section 531(g) of the Deficit Reduction Act of 1984 (P.L. 98-369) prohibited the Treasury Department from issuing, prior to January 1, 1986, any income tax regulations that would provide for inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of (1) the operating costs paid in furnishing the lodging, or (2) the rent received. This moratorium on regulations applied only with respect to qualified campus lodging furnished after December 31, 1983, and before January 1, 1986.

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[26] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H. Con. Res. which passed the House and Senate in the 99th Congress.

[27] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1263; S.Rep. 99-313, pp. 670-672; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 544-545 (Conference Report).

[28] *Bob Jones Univ.* v. *U.S.*, 670 F.2d 167 (Ct. Cl. 1982); *Goldsboro Christian Schools, Inc.* v. *U.S.*, 79-1 CCH USTC para. 9266, E.D.N.C. 1978 (value of lodging furnished to faculty constitutes wages subject to income tax, FICA, and FUTA withholding, in light of "long and consistent history of regulations and rulings, expressly and explicitly applying withholding taxes to lodging not furnished for the employer's convenience***"), *aff'g* order entered in *Goldsboro Christian Schools, Inc.* v. *U.S.*, 436 F.Supp. 1314 (E.D.N.C. 1977), *aff'd* per curiam in unpublished opinion (4th Cir. 1981), *aff'd* 103 S.Ct. 2017 (1983); *Winchell* v. *U.S.*, 564 F.Supp. 131 (D.Neb. 1983) (value of campus home taxed to college president); and *Coulbourn H. Tyler*, 44 CCH Tax Ct. Mem. 1221 (1982).

Qualified campus lodging was defined, for purposes of the moratorium, as lodging furnished by a school, college, or university to any of its employees, including nonfaculty employees, or to the employee's spouse or dependents. The moratorium applied only with respect to employer-furnished lodging that was located on a campus of, or in close proximity to a campus of, the educational institution. Under the 1984 Act, the moratorium did not apply with respect to any amount of the value of lodging if such amount was treated as wages or included in income when furnished.

Reasons for Change

Congress believed that valuation rules should be provided to resolve continuing disagreements between educational institutions and the Internal Revenue Service as to the tax treatment of qualified campus lodging.

Explanation of Provision

The Act provides that, for Federal tax purposes, the fair market value of use (on an annualized basis) of qualified campus lodging furnished by, or on behalf of, an educational institution (within the meaning of sec. 170(b)(1)(A)(ii))[29] is to be treated as not greater than 5 percent of the appraised value for the lodging, but only if an independent appraisal of the fair market value of the lodging is obtained by a qualified appraiser under rules prescribed by the Treasury. Thus, the appraiser is required to be qualified to make appraisals of housing, and the appraisal cannot be made by the employer institution or any officer, trustee, or employee thereof.

Congress did not intend that a new appraisal is to be obtained each year. However, Congress intended that the appraisal is to be reviewed annually, in a manner prescribed by the Treasury, but that such review should not impose undue cost on the educational institution.

Accordingly, under the safe-harbor valuation rule of the Act, if the rent paid for qualified campus lodging is equal to or exceeds on an annualized basis 5 percent of the value determined by such an appraisal, no amount is included, on account of such housing, in the employee's gross income for income tax purposes or in the wage or benefit base for social security and other employment tax purposes.

The provision applies to lodging furnished to any employee of the educational institution (or to the employee's spouse or dependents), including nonfaculty employees, for use as a residence, if the employer-furnished lodging is located on a campus of, or in the proximity of, the educational institution.

If no appraisal is obtained that meets the requirements of the provision, then the fair rental value for tax purposes is to be determined in the manner as would be done absent a special rule, taking into account all the relevant facts and circumstances. This does not preclude a taxpayer whose appraisal is found defective from subsequently obtaining a qualified appraisal and using the safe-harbor rule. For purposes of applying the first sentence of this paragraph to determine the fair rental value of qualified campus lodging, the average of the rentals paid by individuals (other than employees or students of the educational institution) during such year for lodging provided by the educational institution that is comparable to the qualified campus lodging provided to the employee is to be considered the fair rental value.

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[29] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities," and includes both public and private schools (Treas. Reg. sec. 1.170A-9(b)(1)).

The new provision relating to qualified campus lodging does not affect the applicability of section 119(a) to lodging that qualifies for the exclusion in section 119(a).

Effective Date

The provision applies for taxable years beginning after December 31, 1985.

For prior taxable years, it is intended (1) that the IRS is to follow the safe-harbor valuation rule of the Act as if in effect for those years (except with respect to any amount of value of campus lodging that was treated by the taxpayer as wages or included in income when furnished), and (2) that the value of the property as assessed by State or local tax authorities for State or local property tax purposes is to be treated as if it were the value determined by a qualified appraisal.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by less than $5 million annually.

8. Health benefits for retirees (sec. 1167 of the Act)[30]

Prior Law

The Deficit Reduction Act of 1984 (DEFRA) directed the Secretary of the Treasury to study the possible means of providing minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees (including separated employees). The Secretary was required to report to the Congress with respect to the study by February 1, 1985. This study has not yet been completed.

Reasons for Change

Congress extends the due date of the study mandated by DEFRA of retiree benefits to reiterate to the Secretary of the Treasury its interest in obtaining this study.

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[30] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1263; S.Rep. 99-313, pp. 672-674; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 545-546 (Conference Report).

Explanation of Provision

The Act extends the due date of the study of retiree benefits mandated by DEFRA to October 22, 1987.

Effective Date

The provision is effective on October 22, 1986.

Revenue Effect

The provision is estimated to have no effect on fiscal year budget receipts.

9. Accrued vacation pay (sec. 1165 of the Act and sec. 463 of the Code)[31]

Prior Law

Under prior and present law, an accrual-method taxpayer generally is permitted a deduction in the taxable year in which all the events have occurred that determine the fact of a liability and the amount thereof can be determined with reasonable accuracy (the "all-events" test). In determining whether an amount has been incurred with respect to any item during the taxable year, all events that establish liability for such amount are not treated as having occurred any earlier than the time economic performance occurs (sec. 461(h)). With respect to a liability that arises as a result of another person's providing services to the taxpayer (such as the liability to provide vacation pay in exchange for services by an employee), economic performance generally occurs when such other person provides the services.

Under prior and present law, an exception applies under which certain expenses may be treated as incurred in the taxable year in which the "all-events" test is otherwise met even though economic performance has not yet occurred. This exception applies if four conditions are met: (1) the "all-events" test (determined without regard to economic performance) is satisfied with respect to the item during the taxable year; (2) economic performance occurs within a reasonable period (but in no event more than 8½ months) after the close of the taxable year; (3) the item is recurring in nature and the taxpayer consistently from year to year treats items of that type as incurred in the taxable year in which the all-events test is met; and (4) either (a) the item is not material, or (b) the accrual of the item in the year in which the all-events test is met results in a better matching of the item with the income to which it relates than would result from accruing the item in the year in which economic performance occurs. This exception does not apply to workers' compensation or tort liabilities.

In order to ensure the proper matching of income and deductions in the case of deferred benefits (such as vacation pay earned in the current taxable year, but paid in a subsequent year) for employees, an employer generally is entitled to claim a deduction in the taxable year of the employer in which ends the taxable year of the employee in which the benefit is includible in gross income (sec. 404(b)).[32] This rule applies to deferred benefits without regard to the economic performance rules. Consequently, an employer is entitled to a deduction for vacation pay in the taxable year of the employer in which ends the earlier of the taxable year of the employee for which the vacation pay (1) vests (if the vacation pay plan is funded by the employer), or (2) is paid.

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[31] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 907; H.Rep. 99-426, pp. 641-643; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 325; S.Rep. 99-313, pp. 674-676; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 546-548 (Conference Report).

An exception to this rule applies to amounts that are paid within 2½ months after the close of the taxable year of the employer in which the vacation pay is earned. Such amounts are not subject to the deduction-timing rules applicable to deferred benefits, but are subject to the general rules under which an employer is entitled to a deduction when economic performance occurs (i.e., when the services of the employee for which vacation pay is earned are performed). Because amounts paid within 2½ months after the close of the employer's taxable year generally will qualify for the exception to the economic performance requirements, such amounts generally will be deductible for the preceding taxable year (the year in which the vacation pay is earned) even though the employee does not include the benefit in income in the preceding taxable year.

Under a special rule of prior law, an employer could make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for vacation pay (contingent or vested) earned by employees before the close of the current year and expected to be paid by the close of that year or within 12 months thereafter.

Reasons for Change

Congress believed that the special provision (sec. 463) of prior law, under which an employer was entitled to deduct reasonable additions to an account for earned vacation pay expected to be paid within 12 months following the close of the taxable year, was inconsistent with the general principle that no deduction should be provided for a deferred benefit until the employee included the benefit in income. Moreover, Congress believed that the prior-law treatment was inequitable because the rules for accrued vacation pay were more favorable than the rules that applied to other types of compensation or other types of deductible items. Congress believed that the deduction for vacation pay should be subject to no more generous treatment than other items. Consequently, the Act limits the deduction for additions to the reserve for vacation pay to amounts paid within 8½ months following the close of the taxable year. Congress believed that, by permitting an employer to deduct amounts paid within 8½ months after the close of the taxable year, sufficient flexibility is provided to employers to take account of year-end accruals and normal payroll practices.

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[32] Special deduction-timing rules apply to benefits provided under a qualified pension, profit-sharing, or stock bonus plan.

Explanation of Provision

Under the Act, the special rule allowing a deduction for additions to a reserve account for vacation pay (sec. 463) is limited to the vacation pay that is paid during the current taxable year or within 8½ months after the close of the taxable year of the employer with respect to which the vacation pay was earned by the employees.

Effective Date

The provision applies to taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $90 million in 1987, $71 million in 1988, $19 million in 1989, $20 million in 1990, and $17 million in 1991.

10. Military fringe benefits (sec. 1168 of the Act and sec. 134 of the Code)[33]

Prior Law

In general, all types of pay (e.g., basic pay, special pay, incentive pay) of military personnel are included in gross income. Under prior law, a variety of benefits (either in kind or through reimbursements) provided to military personnel and their family members were excludable from gross income. These exclusions were by statute, regulation, or long-standing administrative practice.

Reasons for Change

Congress believed that rules for the tax treatment of military benefits should be consolidated and set forth in one statutory provision. This will better enable taxpayers and the IRS to understand and administer the tax rules. Also, consolidation of these rules made clear the intent of Congress that, consistent with the treatment of benefits generally in the Deficit Reduction Act of 1984, any benefits for military personnel that are not expressly excluded under the new provision or under other statutory provisions of the Code (e.g., sec. 132) are includible in gross income.

Explanation of Provision

The Act excludes from income benefits which were authorized by law, regulation, or administrative practice[34] on September 9, 1986, and which were excludable from income on such date. Benefits are excludable only to the extent of the amount authorized and excludable on September 9, 1986, except that adjustments may be made pursuant to a provision of law or regulation in effect on September

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[33] For legislative background of the provision, see: H.Rep. 99-841, Vol. II (September 18, 1986), pp. 548-549 (Conference Report).

[34] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H. Con. Res. which passed the House and Senate in the 99th Congress.

9, 1986, if the adjustments are determined by reference to fluctuations in cost, price, currency, or other similar index. The provision does not alter the definition of wages for employment tax purposes.

Congress understands that the allowances which were authorized on September 9, 1986, and excludable from gross income on such date are limited to the following: veterans' benefits authorized under 38 U.S.C. sec. 3101; medical benefits authorized under 50 U.S.C. sec. 2005 or 10 U.S.C. secs. 1071-1083; combat zone compensation and combat related benefits authorized under 37 U.S.C. sec. 310; disability benefits authorized under 10 U.S.C. chapter 61; professional education authorized under 10 U.S.C. secs. 203, 205, or 141; moving and storage authorized under 37 U.S.C. secs. 404-412; group term life insurance authorized under 38 U.S.C. secs. 404-412; premiums for survivor and retirement protection plans authorized under 10 U.S.C. secs. 1445-1447; mustering out payments authorized under 10 U.S.C. sec. 771a(b)(3); subsistence allowances authorized under 37 U.S.C. secs. 209, 402; uniform allowances authorized under 37 U.S.C. secs. 415-418; housing allowances authorized under 37 U.S.C. secs. 403, 403a, or 405; overseas cost-of-living allowances authorized under 37 U.S.C. sec. 405; evacuation allowances authorized under 47 U.S.C. sec. 405a; family separation allowances authorized under 37 U.S.C. sec. 427; death gratuities authorized under 10 U.S.C. secs. 1475-1480; interment allowances authorized under 10 U.S.C. secs. 1481-1482; travel for consecutive overseas tours authorized under 37 U.S.C. sec. 416; emergency assistance authorized under 10 U.S.C. sec. 133 and 36 U.S.C. Chapter 1; family counseling services authorized under 10 U.S.C. sec. 133; defense counsel authorized under 10 U.S.C. secs. 133, 801-940, or 1181-1187; burial and death services authorized under 10 U.S.C. sec. 1481-1482; educational assistance authorized under 10 U.S.C. 141 and 37 U.S.C. secs. 203, 209; dependent education authorized under 20 U.S.C. sec. 921 and 10 U.S.C. sec. 7204; dental care for military dependents authorized under 10 U.S.C. secs. 1074 or 1078; temporary lodging in conjunction with certain orders authorized under 37 U.S.C. sec. 404a; travel to a designated place in conjunction with reassignment in a dependent-restricted status authorized under 37 U.S.C. sec. 406; travel in lieu of moving dependents during ship overhaul or inactivation authorized under 37 U.S.C. sec. 406b; annual round trip for dependent students authorized under 37 U.S.C. sec. 430; travel for consecutive overseas tours (dependents) authorized under 37 U.S.C. sec. 411b; and travel of dependents to a burial site authorized under 37 U.S.C. sec. 411f.

Congress intends this list to be an exhaustive list of the allowances excludable under the new provision. The list is not intended, however, to limit benefits which are excludable under another section of the Code. Further, Congress recognizes that there may be benefits which may have been unintentionally omitted from the list. Accordingly, the Secretary of the Treasury is authorized to expand the list if the Secretary finds that a benefit should have been included, i.e., that the benefit was authorized on September 9, 1986, and excludable from income on such date, or is a modification of an in-kind benefit authorized on September 9, 1986. Except as provided in the preceding sentence, the Secretary of the Treasury may not, by regulation or otherwise, expand the definition of excludable military benefits.

The Act does not provide for the exclusion from income for personal use of a vehicle provided to military personnel.[35]

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

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[35] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in the versions of H. Con. Res. 395 which passed the House and Senate in the 99th Congress.

G. Employee Stock Ownership Plans (ESOPs)

An employee stock ownership plan ("ESOP") is a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan under which employer stock is held for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts) which is exempt under section 4975. Under present and prior law, an ESOP is required to be designed to be invested primarily in employer securities.

1. Changes in qualification requirements relating to ESOPs (secs. 1174-1176 of the Act and secs. 401, 415, and 409 of the Code) [1]

Prior Law

In general

Under prior and present law, ESOPs are subject to the requirements generally applicable to qualified plans. A qualified plan is required to meet minimum standards relating to coverage (sec. 410), vesting (sec. 411(a)), benefit accruals (sec. 411(b)), and funding (sec. 412). Also under prior and present law, a qualified plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 401(a)(4)).

Prior and present law provide that, unless a participant otherwise elects in writing, the payment of benefits from a qualified plan generally is to begin no later than 60 days after the close of the plan year in which occurs the latest of (1) the date on which the participant attains the normal retirement age under the plan (or age 65, if earlier), (2) the 10th anniversary of the year the participant commenced participation in the plan, or (3) the date the participant separates from service. In no event can distribution be deferred beyond the required beginning date (sec. 401(a)(9)).

An ESOP that is top-heavy is also subject to the qualification rules applicable generally to top-heavy plans, including, for example, accelerated vesting and limits on compensation taken into account under the plan.

Diversification of investments

Under prior and present law, the Employee Retirement Income Security Act of 1974 (ERISA) subjects the trustee of a qualified plan to a fiduciary requirement that plan assets be adequately diversified. In addition to this fiduciary requirement, a trustee of a qualified plan generally may not invest more than 10 percent of the plan's assets in employer securities. An exception to this 10-percent restriction applies in the case of a profit-sharing or stock bonus plan, including an ESOP. Thus, the trustee of an ESOP may invest up to 100 percent of the plan's assets in employer securities.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1173; H.Rep. 99-426, pp. 783-794; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1275; S.Rep. 99-313, pp. 684-691; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 550-560 (Conference Report).

Voting rights

In addition to the generally applicable qualification rules, under prior and present law, ESOPs are required to satisfy special qualification requirements. For example, an ESOP that is maintained by an employer that has registration-type securities is required to provide that each participant is entitled to direct the trustee how to vote shares allocated to the participant's account. Under prior law, if the employer maintaining the ESOP did not have registration-type securities, the ESOP was required to provide that each participant was entitled to direct the trustee in the exercise of voting rights on any corporate issue that, by law or charter, is required to be decided by more than a majority vote of outstanding common shares voted (sec. 409(e)(3)).

Special limit on contributions

In order to limit the extent to which individuals can use tax-favored arrangements to provide for employee benefits under a qualified plan, prior and present law provide limits on contributions and benefits under qualified pension, profit-sharing, and stock bonus plans (sec. 415). Prior and present law provide a special limitation on annual additions under an ESOP. Prior law provided that, under this special rule, the usual dollar limit on annual additions ($30,000 for 1987) was increased if the ESOP provided that no more than 1/3 of the employer contributions for the year were allocated to the group of employees consisting of officers, 10-percent shareholders, and highly compensated employees (i.e., employees whose annual compensation exceeded twice the dollar limit on annual additions or $60,000 for 1987) (sec. 415(e)(6)).

Put option

Under prior and present law, a participant in an ESOP who is entitled to a distribution under the plan has the right to demand that the participant's benefits be distributed in the form of employer securities. Further, if the employer securities are not readily tradable on an established market, then the participant has the right (i.e., a "put option") to require that the employer repurchase the employer securities under a fair valuation formula.

An employer is treated as satisfying this put option requirement if the employer provides a put option for a period of at least 60 days following the date of distribution of the employer securities and, if the put option is not exercised during this period, an additional 60-day period during the following plan year.

If the put option is exercised, provision for payment is to be reasonable. If payment is deferred, the payment provisions will not be considered reasonable unless the employer provides a reasonable rate of interest and, in certain cases, security with respect to the payment.

Tax-credit ESOPs

Under prior law, an ESOP under which an employer contributed employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability was referred to as a tax-credit ESOP. This credit was initially investment-based (and the plans were called TRASOPs due to their origin in the Tax Reduction Act of 1975), but was payroll-based after 1982 (and the plans were called PAYSOPs).

Under present and prior law, tax-credit ESOPs are subject to the requirements generally applicable to qualified plans and ESOPs. In addition, tax-credit ESOPs are subject to special qualification requirements. In general, under prior and present law, employer securities allocated to an employee's account under a tax-credit ESOP may not be distributed before the end of the 84th month after the month in which the securities were allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service, death, or disability, or in the case of certain corporate acquisitions. Under prior law, distributions of employer securities were generally not permitted upon termination of a tax-credit ESOP unless the 84-month rule was satisfied.

Reasons for Change

Congress was concerned that the prior-law rules encouraging ESOPs provided tax benefits to employers and others engaged in ESOP transactions without ensuring increased rights of ownership for participating employees. In addition, Congress was concerned that employees for whom an ESOP provided a major source of retirement savings could be disadvantaged due to the fact that those savings could be invested exclusively in employer securities. To minimize that concern, Congress found it appropriate to require ESOPs to allow certain plan participants approaching retirement age to elect partial diversification of their ESOP account balance.

With respect to the distribution rules applicable to ESOPs, the Act substantially shortens the distribution period permissible under prior law and amends the put option provisions to protect employees without adversely affecting the financial solvency of employers. Congress recognized that employers must be permitted an extended period of time to make large payments and that requiring more rapid payment may jeopardize the company and undermine the value of accounts for other employees (for example, if the company encounters liquidity problems due to the need to make large payments to participants). Similarly, Congress believed that enabling a sponsoring employer to disregard "loan shares" (i.e., shares acquired with the proceeds of an exempt loan) enables an employer to plan its ESOP loan repayment schedule (i.e., without liabilities triggered by stock repurchase obligations).

The Act also promotes administrative ease by ensuring that amounts can be distributed, transferred to another plan, or rolled over when a tax-credit ESOP is terminated. The prior-law distribution restriction for tax-credit ESOPs required an employer to maintain a tax-credit ESOP until 84 months after the last date stock was allocated. This rule originated with the investment tax-credit

ESOP to ensure that distributions were coordinated with the 7-year investment tax-credit recapture period, a concept with less relevance when the ESOP credit was based on payroll. Thus, Congress saw no purpose in restricting distributions or in otherwise limiting transfers or rollovers to other qualified plans upon plan termination.

Finally, Congress believed that greater uniformity would reduce complexity in the tax laws. Therefore, the Act extends to stock bonus plans the put option requirements applicable to ESOPs and adopts, for purposes of the special section 415 limit for ESOPs, the uniform definition of highly compensated employees adopted generally under the Act.

Explanation of Provisions

Overview

The Act modifies several of the qualification requirements applicable to ESOPs and stock bonus plans. In general, the Act (1) requires that ESOPs provide certain plan participants with the right to diversify partially their account balances; (2) permits distributions from tax-credit ESOPs upon plan termination; (3) modifies the rules relating to the timing and form of distributions from ESOPs; (4) requires the use of an independent appraiser to value nonpublicly traded employer securities held by an ESOP; (5) eliminates pass-through voting in the case of an ESOP maintained by certain closely held newspapers; and (6) modifies the put option requirements applicable to ESOPs and extends those modified requirements to stock bonus plans.

Diversification of investments

In general

The Act requires an ESOP to offer a partial diversification election to participants who meet certain age and participation requirements (qualified participants). Under the Act, a qualified participant is entitled annually during any diversification election period following each plan year in the participant's qualified election period to direct diversification of up to 25 percent of the participant's account balance (50 percent in the last election period). The participant's account balance, for purposes of any diversification election period, consists of assets actually allocated by the end of the prior plan year. To the extent that a participant elects to diversify a portion of the account balance, the Act requires an ESOP to offer at least 3 investment options not inconsistent with regulations prescribed by the Secretary and to complete the diversification within a specified period.

Under the Act, a distribution to the participant and, in some cases, transfer to another qualified plan within 90 days after the close of the annual diversification election period of an amount not to exceed the maximum amount for which a participant elected diversification is deemed to satisfy the diversification requirement with respect to such amount.

Qualified election period; qualified participants

Under the Act, an ESOP is required to provide an annual diversification election period for the 90-day period following the close of the ESOP plan year. Thus, for 90 days after the end of a plan year, an ESOP is to permit an election by those qualified participants who become or remain eligible to make a diversification election during the plan year. Under the Act, any participant who has attained at least age 55 and completed at least 10 years of participation in the plan is a qualified participant. A qualified participant may modify, revoke, or make a new election at any time during the 90-day election period.

Any qualified participant is permitted to make a diversification election during each diversification election period following each plan year in the participant's qualified election period. A qualified participant's qualified election period generally begins with the plan year during which the participant attains age 55 and ends with the fifth succeeding plan year.[2] If, however, the participant has not completed 10 years of plan participation by the end of the plan year in which the participant attains age 55, the qualified election period begins with the plan year in which the participant completes 10 years of plan participation and ends with the fifth succeeding plan year.[3]

For example, in the case of an ESOP using the calendar year as the plan year, a participant who completes 10 years of plan participation before attaining age 55 and who attains age 55 in 1990, becomes a qualified participant in the plan year beginning January 1, 1990. That participant will be eligible to direct diversification during the 90-day election period beginning January 1, 1991, and will remain eligible to direct diversification during the annual election periods in 1992, 1993, 1994, 1995, and 1996.

Similarly, if the participant completes 10 years of participation in 1990 when the participant is 58, the participant becomes a qualified participant in the plan year beginning January 1, 1990. The participant will be eligible to direct diversification during the election periods in 1991, 1992, 1993, 1994, 1995, and 1996.

The qualified election period does not begin before the first plan year beginning after December 31, 1986.[4] Thus, for example, if a participant in a calendar year ESOP attained age 55 and had 10 years of plan participation in 1986, the participant would be eligible to make a diversification election during the election periods in 1988, 1989, 1990, 1991, 1992, and 1993.

The diversification requirement applies with respect to participants who have separated from service with the employer. For example, assume a participant in a calendar year ESOP terminates employment in 1987, when the participant has 10 years of participation and is age 54. The participant's account balance remains in the plan. The participant will become a qualified participant beginning in 1988 (the year in which the participant attains age 55), and will be eligible to direct diversification during the annual election periods in 1989, 1990, 1991, 1992, 1993, and 1994.

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[2] A technical correction may be needed so that the statute reflects this intent.

[3] A technical correction may be needed so that the statute reflects this intent.

[4] A technical correction may be needed so that the statute reflects this intent.

Amount eligible for diversification

With respect to any diversification election other than the last diversification election to which the participant is entitled, the amount of a participant's account balance subject to the diversification election is 25 percent of the sum of (1) the participant's account balance at the end of the prior plan year, and (2) prior distributions or transfers during the qualified election period. This amount subject to the diversification election is then reduced by any amounts previously diversified (including amounts distributed or transferred to meet the diversification requirement) in order to obtain the amount currently eligible for diversification. With respect to the last diversification election, the percent eligible for diversification is 50 percent, rather than 25 percent. Because these rules permit diversification not to exceed a cumulative amount, the scope of each year's election depends, in part, on prior elections. For purposes of determining the amount subject to diversification, amounts distributed to the participant or transferred in satisfaction of the diversification rules during the qualified election period are considered amounts diversified.

Congress intended the Secretary to issue regulations providing that no separate diversification election is required for de minimis amounts. In addition, in no event will an ESOP be required to permit a participant to direct that amounts previously diversified be reinvested in employer securities due to decreases in the value of the account balance.

A plan may permit the participant to elect to diversify a greater percentage of the participant's account balance, subject, of course, to applicable qualification rules.

These rules are illustrated by the following example. Assume a participant with 10 years of participation in an ESOP attains age 55 during the 1987 plan year and that the ESOP uses a calendar year plan year. During the 90-day period beginning on January 1, 1988, and ending on March 30, 1988, the participant may direct the trustee to diversify up to 25 percent of the participant's account balance. If the participant elects to direct diversification of the maximum amount—25 percent—the only amounts for which the participant may elect diversification during the 1989, 1990, 1991, and 1992 election periods are amounts attributable to increases in the participant's account balance, whether attributable to earnings or additional contributions. However, pursuant to regulations to be issued by the Secretary, no diversification election is required for de minimis amounts.

From January 1, 1993, to March 31, 1993, the participant is to be given the opportunity to direct diversification of up to 50 percent of the sum of (1) the participant's account balance at the end of the 1992 plan year and (2) the amounts previously distributed or transferred to meet the diversification requirements. This amount is then reduced by amounts previously diversified (including amounts previously distributed or transferred to meet the diversification requirements) in order to obtain the amount eligible for diversification. For example, assume the participant's account balance on December 31, 1992, is $5,000. The amounts diversified prior to December 31, 1992, total $1,000, $500 of which was distributed. The participant can elect to diversify up to $1,750 [(50% x $5,500) - $1,000]. Whether or not this participant directs diversification in 1993, no further diversification election is required to be provided to the participant.

Alternatively, if the participant did not elect diversification during the 1988 election period, a similar election would be available during the 1989, 1990, 1991, and 1992 election periods. In each year, the participant could elect to direct diversification with respect to that portion of the account balance that, when aggregated with prior amounts for which diversification was elected, did not exceed 25 percent of the account balance at the end of the prior plan year (increased by prior distributions or transfers during the qualified election period).

If the participant did not elect diversification during the 1988-1992 election periods, a final election would be available in 1993 (the last election period in which the participant is entitled to make a diversification election) to direct diversification of up to 50 percent of the participant's account balance (increased by prior distributions or transfers during the qualified election period).

Implementation of diversification

No later than 90 days after the close of the election period, the plan is to complete diversification pursuant to participant elections. The 90-day period applies regardless of the method used to implement diversification elections.[5] The plan may satisfy this requirement by (1) distributing to the participant an amount equal to the amount for which the participant elected diversification, or (2) substituting for the amount of the employer securities for which the participant elected diversification an equivalent amount of other assets, in accordance with the participant's investment direction. The ESOP is to offer at least 3 investment options (not inconsistent with regulations prescribed by the Secretary).

It is expected that the plan administrator will notify participants of their rights to diversify a portion of their account balances.

Any distribution made to satisfy a diversification election is subject to applicable consent rules.[6] Thus, for example, if the present value of the participant's accrued benefit is greater than $3,500, no amount may be distributed without the consent of the participant and, where applicable, the consent of the participant's spouse. If the plan offers to distribute the appropriate amount and the required consent is not provided, the plan is deemed to have satisfied the diversification requirement.

If the plan provides a distribution, the distribution can consist of the assets in the account, e.g., employer stock or cash in lieu of employer stock. If, under this rule, stock is distributed in satisfaction of the diversification requirement, the usual put option rules apply. Amounts that are distributed in satisfaction of the diversification requirement may be rolled over into an IRA or another qualified plan without regard to the general requirements for rollovers (sec. 402(a)(5)(D)(i)).

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[5] A technical correction may be needed so that the statute reflects this intent.

[6] See, e.g., secs. 411(a)(11) and 417.

To the extent that a distribution is made to satisfy the diversification requirement, the 84-month holding period requirement applicable to tax-credit ESOPs does not apply.[7] This exception to the 84-month rule applies only to the extent that the diversification requirement cannot be satisfied by distributing employer securities that have already met the 84-month rule.

If the plan does not make the amount the participant elects to diversify available for distribution, then the plan is to provide at least 3 investment options (not inconsistent with regulations prescribed by the Secretary). These options may, but need not, include an option to permit full self-direction by the participant. It is not intended that the plan offer employer securities as one of the diversification options.

The diversification requirement may be satisfied if an employer provides the participant the option to transfer the portion of the account balance for which diversification is elected into a qualified plan which provides for employee-directed investment and in which the required diversification options are available. Of course, any transfer is required to comply with applicable qualification rules.

Whether or not the plan trustees must actually sell employer securities to satisfy the diversification elections depends, in part, on the extent to which the ESOP is invested in employer securities. Provided the amount of total trust assets invested in assets other than employer securities is greater than the total amount for which diversification is elected, it may be possible to complete diversification without disposing of employer securities by allocating alternative assets to electing participants' accounts or by disposing of such alternative assets and reinvesting the proceeds in the investments directed by participants.

Distributions upon plan termination

The Act amends the tax-credit ESOP distribution provisions to permit certain distributions upon plan termination without establishment of a successor plan.[8] Distributions eligible to be made upon plan termination are to consist of the entire balance to the credit of the participant.[9]

It is intended that, for purposes of the rule permitting distributions from a tax-credit ESOP on termination of the plan, a termination includes a partial termination of such a plan as to the employees of a particular subsidiary or operating trade or business in situations where such employees no longer have a significant relationship with the sponsor of the plan.

Timing of distributions

The Act modifies the rules relating to the timing and form of required distributions. Under the Act, an ESOP is to permit earlier distributions to employees who separate from service before normal retirement age. Unless an employee otherwise elects in writing, the payment of benefits under an ESOP is to begin no later than 1 year after the later of the plan year (1) in which the participant terminates employment due to retirement on or after the normal retirement age under the plan, disability, or death, or (2) which is the fifth plan year following the participant's separation from service for any other reason. In the case of separation from service for reasons other than retirement on or after normal retirement age, death, or disability, distributions are not required to begin if the participant returns to service with the employer prior to the time distribution is otherwise to begin under the rule.[10]

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[7] A technical correction may be needed so that the statute reflects this intent.
[8] A technical correction may be needed so that the statute reflects this intent.
[9] A technical correction may be needed so that the statute reflects this intent.

The Act provides an exception to the general rule on availability of a distribution in the case in which any portion of a participant's account balance consists of securities for which any portion of an acquisition indebtedness related to such securities is outstanding. Therefore, if a portion of a participant's account balance consists of employer securities which were acquired with the proceeds of an exempt loan that has not been fully repaid, the exception applies to that portion of the account. Under this exception, distributions of such portion of the account balance are not required to be made available to a participant under the general rule until the plan year following the plan year in which the loan is fully repaid. It is intended that the Secretary may prescribe rules with respect to the application of the special rule in the case of refinancings.

Unless the participant elects a longer distribution period in accordance with the plan, distribution of the participant's account balance is to be made in substantially equal payments (not less frequently than annually) over a period no greater than 5 years, beginning with the date distributions are required to commence under the ESOP distribution rule described above.

If the participant's account balance determined on the valuation date immediately preceding the date distributions are to begin under the ESOP distribution rule or the valuation date immediately preceding such valuation date exceeds $500,000, the 5-year period is extended by 1 year (up to 5 additional years) for each $100,000 (or fraction thereof) by which the account balance exceeds $500,000. These dollar amounts are indexed at the same time and in the same manner as the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)).

The following example illustrates the new distribution rules:

Assume a participant separates from service in 1988 for reasons other than retirement on or after normal retirement age, death, or disability. A portion of the participant's account consists of employer securities which were acquired with an exempt loan that will not be fully repaid until 1992. The plan year is the calendar year.

Under the general rule relating to the commencement of distributions, unless the participant elects otherwise, distribution of the portion of the account that does not consist of securities acquired with an exempt loan is to begin no later than the close of the 1994 plan year. Because the loan will be fully repaid prior to that time, distribution of the remainder of the account balance is also required to begin at that time. If the participant's account balance on the valuation date does not exceed $500,000, unless the participant elects otherwise, distribution of the entire account balance is to be made in substantially equal payments not less frequently than annually over the period December 31, 1994, through December 31, 1999.

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[10] A technical correction may be needed so that the statute reflects this intent.

If the exempt loan is not repaid until 1994, then distribution of the portion of the account consisting of securities acquired with such loan does not have to begin until the close of 1995. Distribution of the account balance is to be completed by the end of the 5-year period which begins on December 31, 1994. If the loan is not repaid until after 2000, then the remainder of the account is to be distributed by the end of the 2001 plan year.

The rules added by the Act are intended as an acceleration of the otherwise applicable benefit commencement date. Accordingly, if the general rules (secs. 401(a)(9) and 401(a)(14)) require the commencement of distributions at an earlier date, those general rules override the special ESOP rules.

Independent appraiser

Under the Act, with respect to all activities carried on by the plan, all valuations of employer securities contributed to or purchased by an ESOP that are not readily tradable on an established securities market are to be made by an independent appraiser (within the meaning of sec. 170(a)(1)). The appraiser's name is to be reported to the Internal Revenue Service.

Voting

The Act eliminates the pass-through voting requirements of prior law (sec. 401(a)(22)) in the case of employer securities issued by an employer (determined without regard to the controlled group rules) whose stock is not publicly traded and a substantial portion of whose business consists of publishing a newspaper for general circulation on a regular basis. The Act also permits ESOPs established by such employers to acquire nonvoting common stock in certain cases.

Certain other changes to the voting requirements are made in the technical corrections portion of the Act.

Put option requirements

The Act generally retains the prior-law requirement that a participant in an ESOP who is entitled to a distribution of employer securities is to be given a put option with respect to distributed employer securities that are not readily tradable. However, the Act modifies the permissible periods over which the employer may pay the option price to the participant. The modifications contained in the Act apply with respect to all distributions, not merely the accelerated distributions added by the Act.

In the case of a total distribution of employer securities to a participant that are put to the employer, the Act provides that the employer is to pay the option price to the participant in substantially equal annual payments over a period not exceeding 5 years and beginning not more than 30 days after the exercise of the put option. The employer is required to provide security with respect to such installment payments, and is required to credit a reasonable rate of interest with respect to the outstanding balance of the option price.

A total distribution means the distribution within 1 taxable year of the recipient of the account balance under the plan.

In the case of a put option exercised with respect to an installment distribution, the employer is required to pay the option price within 30 days after the exercise of the option. An installment distribution is any distribution that is not a total distribution.

Extension of put option requirements to stock bonus plans

Under the Act, distributions from a stock bonus plan of employer securities that are not readily tradable on an established securities market are subject to the put option requirements applicable to ESOPs.

Modification of limitations on annual additions to ESOPs

Under the Act, the definition of an employee who is subject to the ⅓ allocation limit for purposes of the special limitation on annual additions to ESOPs (sec. 415(c)(6)) is modified to conform to the new definition of highly compensated employee added under the Act for purposes of qualified pension, profit-sharing, or stock bonus plans, and for purposes of employee benefit plans.

Effective Dates

The diversification requirement and the independent appraiser requirement are effective for stock acquired after December 31, 1986.

The provision permitting distributions upon the termination of a tax-credit ESOP is effective with respect to distributions occurring after December 31, 1984.[11] The other distribution requirements, the put option requirements, and the extension of the put option requirements to stock bonus plans are effective with respect to distributions attributable to stock acquired after December 31, 1986, except that a plan may elect to have the put option requirements apply to all distributions after October 22, 1986.

The modified definition of highly compensated employees is effective for years beginning after December 31, 1986.

The elimination of the pass-through voting requirements for certain plans of newspapers is effective December 31, 1986. The provision permitting certain plans of newspapers to acquire nonvoting common stock is effective with respect to acquisitions of securities after December 31, 1986.

2. Repeal of employee stock ownership credit (sec. 1171 of the Act and sec. 41 of the Code)[12]

Prior Law

Overview

An ESOP under which an employer contributed employer securities (or cash with which to acquire employer securities) under prior

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[11] A technical correction may be needed so that the statute reflects this intent.

[12] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1171; H.Rep. 99-426, pp. 794-796; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1272; S.Rep. 99-313, pp.

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law in order to qualify for a credit against income tax liability is referred to as a tax-credit ESOP. Under present and prior law, a tax-credit ESOP is required to satisfy additional special requirements, including rules relating to vesting, allocation of employer contributions, and distribution rules.

Limits on tax credits

Under prior law, for taxable years ending after December 31, 1982, an electing employer was allowed an income tax credit for contributions to a tax-credit ESOP limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 through 1987, the tax credit was limited to ½ of 1 percent of compensation. No tax credit was permitted for compensation paid or accrued in calendar years beginning after 1987.

Prior law provided that no payroll-based tax credit was allowed for contributions to a plan if more than ⅓ of the employer's contribution for the year was allocated to the group of employees consisting of officers, 10-percent shareholders, or individuals whose compensation exceeded a specified limit (for 1987, $60,000) (sec. 415(c)(6)).

The amount of the employer's income tax liability that could have been offset by the payroll-based tax credit for contributions to a tax-credit ESOP generally was limited to the first $25,000 of tax liability, plus 85 percent of the excess over $25,000 (sec. 38(c)).[13] If the tax credit exceeded the amount of tax liability against which the credit could be applied for a taxable year, certain carrybacks and carryforwards were provided.[14]

Reasons for Change

Congress was interested in retaining certain tax incentives for ESOPs. However, in evaluating the relative tax benefits provided for ESOPs, Congress concluded that other incentives (including the financing incentives added by the Deficit Reduction Act of 1984 (DEFRA)) were more important than the ESOP tax credits. Thus, in order to raise sufficient revenue to add additional tax incentives for ESOP financing and to expand the incentives added by DEFRA, Congress believed it was appropriate to repeal the special ESOP tax credit at the end of 1986.

Explanation of Provision

The Act repeals the special ESOP tax credit.

678-679; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 553, 556, and 558 (Conference Report).

[13] If the employer was a member of a controlled group of corporations, the $25,000 amount against which the tax credit may be fully applied was reduced by apportioning such amount (pursuant to Treasury regulations) among the member corporations (sec. 38(c)(3)(B)).

[14] The unused tax credit could have been carried back to each of the 3 preceding taxable years and carried forward to each of the 15 succeeding taxable years (sec. 39(a)). The amount of any unused credit that expired at the end of the last taxable year to which it could have been carried was allowed as a deduction to the employer for such taxable year without regard to the usual limits on deductions for employer contributions to qualified plans (sec. 404(i)).

Effective Date

The credit is repealed with respect to compensation paid or accrued after December 31, 1986. Of course, credits to which an employer became entitled prior to January 1, 1987, are not affected by this provision.

3. Certain additional tax benefits relating to ESOPs (secs. 1172, 1173, and 1854 of the Act and secs. 133, 404, 409, 4979A, and new sec. 2057 of the Code)[15]

Prior Law

Deduction for dividends paid on employer securities

Under prior and present law, an employer is entitled to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an ESOP (including a tax-credit ESOP). Under prior law, this deduction was available for a taxable year only to the extent the dividends are actually paid out currently to participants or beneficiaries (sec. 404(k)).

Under prior and present law, the deduction is allowed with respect to dividends that are (1) in accordance with the plan provisions, paid in cash directly to the participants, or (2) paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the end of the plan year in which the dividends are paid to the plan.

For income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or paid to the plan and distributed to participants, generally are treated as plan distributions. Such dividends do not qualify for the partial exclusion from income otherwise permitted under the Code (sec. 116).

Partial exclusion of interest earned on ESOP loans

Under prior and present law, a bank, an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan made after July 18, 1984 (the date of enactment of DEFRA), and used to acquire employer securities after such date. A "securities acquisition loan" is defined as a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of section 409(l)) for the ESOP. A securities acquisition loan does not include any loan between corporations that are members of the same controlled group of corporations.

Temporary regulations issued by the Treasury provided that a loan made by a commercial lender to a corporation sponsoring an ESOP qualifies as a securities acquisition loan only to the extent that, and for the period that, the proceeds are (a) loaned to the corporation's ESOP under a loan that qualifies as an exempt loan under section 4975 and that has "substantially similar" terms as the loan from the commercial lender to the sponsoring corporation, and (b) used to acquire employer securities for the ESOP.

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[15] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 1172 and 1175; H.Rep. 99-426, pp. 797-799; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1273 and 1274; S.Rep. 99-313, pp. 669-684; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 553, 556, 558-560 (Conference Report).

Under the temporary regulations, the terms of the loan from the commercial lender to the sponsoring corporation and the terms of the loan from such corporation to the ESOP are treated as substantially similar only if the timing and rate at which employer securities would be released from encumbrance under the loan from the commercial lender if such loan were the exempt loan are substantially similar to the timing and rate at which employer securities are actually released from encumbrance in accordance with section 4975.[16] Thus, the temporary regulations match the timing of the repayment of the loan to the corporation with the allocation of shares in the ESOP, and provide that allocation of shares is required to occur as rapidly as repayment of the loan to the corporation.

The temporary regulations also provide that section 133 does not apply to loans made after July 18, 1984, to the extent that such loans are renegotiations, including refinancings, of loans outstanding on that date.[17]

Reasons for Change

Congress believed that it was appropriate to expand on the incentives that advance the idea of broader capital ownership and employee stock ownership in particular.

Congress felt it appropriate to encourage corporations to borrow money in order to make a contribution of stock to employees' accounts that could be immediately allocated (versus limiting the provision to those corporations utilizing a "leveraged ESOP" whereby employees' shares are held in a suspense account pending payment of the leveraged ESOP loan). It was felt that this approach would prove a valuable supplement to leveraged ESOPs by encouraging companies to borrow on behalf of their employees while ensuring that employees receive a stock allocation immediately and begin receiving dividend payments on such stock more rapidly.

Congress also believed it was appropriate to permit the interest income on securities acquisition loans qualified under section 133 to be received by the shareholders of regulated investment companies making such loans.

Further, in order to accelerate the repayment of ESOP loans, Congress found it appropriate to permit a deduction for dividends on employer securities if such dividends are used to make payments on an ESOP loan.

Finally, to provide relief from estate taxes and to encourage the increased transfer of employer securities to ESOPs, Congress provided a partial deduction for an estate for the proceeds realized on certain sales of employer securities to an ESOP or to certain worker-owned cooperatives.

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[16] Temp. Treas. Reg. sec. 1.133-1T Q&A 1.

[17] Temp. Treas. Reg. sec. 1.133-1T Q&A 4.

Explanation of Provisions

Estate tax deduction for sales to an ESOP[18]

The Act permits a deduction from the gross estate of 50 percent of the qualified proceeds from a qualified sale of employer securities. Under the Act, a qualified sale means any sale of employer securities (within the meaning of sec. 409(l)) by an executor to (1) an ESOP described in section 4975(e)(7), or (2) an eligible worker-owned cooperative (as defined in sec. 1042(c)(2)).

Under the Act, qualified proceeds are defined to mean the proceeds received from the sale of employer securities issued by a domestic corporation if the sale occurs at any time before the due date of the estate tax return (including extensions of time to file). Qualified proceeds do not include the proceeds from the sale of any employer securities if the securities were received by the decedent (1) from a qualified plan (within the meaning of sec. 401(a)), or (2) as a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

Under IRS Notice 87-13, the estate tax deduction is not available unless (1) the decedent directly owned the employer securities immediately before death, and (2) after the sale, the employer securities are allocated to plan participants or are held for future allocation in connection with an exempt loan under section 4975 or in connection with a transfer of assets from a defined benefit plan under the rules of section 4980(c)(3). Except in the case of a bona fide business transaction (e.g., a substitution of employer securities in connection with a merger of employers), employer securities are not treated as allocated or held for future allocation to the extent that such securities are allocated or held for future allocation in substitution for other employer securities that had been allocated or held for future allocation.

Under the Act, certain penalties apply if any portion of the assets attributable to employer securities acquired in a qualified sale accrue or are allocated during the nonallocation period for the benefit of (1) a decedent whose estate makes such a sale, (2) any person who is related to the decedent in one of the ways described in section 267(b), or (3) any other person who owns (after application of the attribution rules of sec. 318(a) as modified for this purpose) more than (a) 25 percent (by number) of any class of outstanding stock of the corporation (or certain related corporations) that issued such qualified securities, or (b) more than 25 percent of the total value of any class of outstanding stock of the corporation (or certain related corporations). The nonallocation period is the period beginning on the date of the sale and ending on the date that is 10 years after the later of (1) the date of sale or (2) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale.[19]

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[18] H.R. 1311 and S. 591 (100th Cong.) would make modifications to section 2057. The modifications are designed to conform the provision to Congressional intent and to reduce the revenue loss of the provision to the original level estimated during consideration of the Tax Reform Act of 1986.

[19] A technical correction may be needed so that the statute reflects this intent.

The Act makes it clear that this restriction applies to penalize any direct or indirect accrual of benefits under any qualified plan of the employer or an allocation of assets under any such plan attributable to the securities involved in the qualified sale (or assets in lieu of such securities). Thus, for example, an ESOP in which the decedent has an interest should not allocate to the decedent's account any assets attributable to the securities involved in the sale. Nor should the employer make an allocation under the plan or any other qualified plan of the employer of other assets to the decedent in order to make up for the failure to allocate the securities involved in the qualified sale. The restriction is not intended to apply to amounts which are provided to the individual outside of a qualified plan, for example, through a nonqualified deferred compensation agreement.

The Act clarifies that an individual is to be treated as a 25-percent shareholder only if the individual is a 25-percent shareholder (1) at any time during the 1-year period ending on the date of a qualified sale to an ESOP, or (2) on the date as of which any of the securities sold to the ESOP in a qualified sale are allocated. In the case of an individual who satisfies the condition described at (1), the individual will continue to be treated as a 25-percent shareholder until all of the securities acquired pursuant to the qualified sale are allocated. In the case of an individual who does not satisfy the condition described at (1), but meets the condition described at (2), the individual will be treated as a 25-percent shareholder only with respect to those securities allocated as of the date or dates that the individual is a 25-percent shareholder.

The Act also provides that, for purposes of determining whether an individual owns more than 25 percent of the outstanding stock of the corporation (or related corporation) that issued the employer securities, all allocated securities held by a qualified plan are treated as securities owned by the plan participant to whom the securities are allocated.

Under the Act, individuals who would be ineligible to receive an allocation of securities solely because they are lineal descendants of the decedent may receive an allocation of the securities acquired in the qualified sale provided that the total amount of such securities (or amounts in lieu thereof) allocated to all such lineal descendants is not more than 5 percent of all employer securities acquired in the qualified sale.[20] For purposes of determining whether lineal descendants of a decedent have been allocated more than 5 percent of the employer securities to which section 2057 applies (or amounts in lieu thereof), all employer securities sold to the ESOP by the decedent that are eligible for section 2057 treatment are taken into account.

There are 2 sanctions for failure to comply with the allocation restriction. First, the Act requires that an ESOP that acquires securities in a qualified sale is required to provide that the restriction on the allocation of securities to the sellers, family members, and 25-percent shareholders will be satisfied. Failure to comply with this requirement results in disqualification of the plan with respect to those participants who received prohibited allocations. Thus, failure to comply results in income inclusion for those participants of the value of their prohibited allocations on the date of such allocations.

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[20] A technical correction may be needed so that the statute reflects this intent.

Second, if there is a prohibited allocation or accrual, then a 50 percent excise tax is imposed on the amount involved in the prohibited allocation. This excise tax is to be paid by the employer who maintains the ESOP or by the eligible worker-owned cooperative. The deduction provided by section 2057 does not apply unless the employer files with the Secretary a written statement acknowledging its potential liability for the 50 percent excise tax.

Deduction for dividends paid on employer securities

Under the Act, the deduction for dividends paid on employer securities is expanded to apply to dividends that are used to make payments on ESOP loans (including payments of interest as well as principal). Such repayments are not treated differently from repayments attributable to nondeductible dividends for purposes of applying the limit on employer deductions (sec. 404(j)) or for purposes of applying the limitations on benefits and contributions (sec. 415).

With respect to allocated employer securities, the deduction for dividends paid on employer securities is available only to the extent that the dividends are paid out currently to plan participants or beneficiaries. With respect to unallocated employer securities, the deduction is available to the extent that the dividends are used to repay acquisition indebtedness incurred to acquire the employer securities on which the dividends are paid or are paid out currently to participants or beneficiaries in proportion to the stock allocated to their accounts.

Partial exclusion of interest earned on ESOP loans

Definition of securities acquisition loan

In general.—The Act makes several changes to the definition of "securities acquisition loan." The Act (1) clarifies the definition of securities acquisition loan in the case of a loan to a sponsoring corporation with a corresponding loan from the sponsoring corporation to the ESOP ("back-to-back" loans); (2) includes in the definition of securities acquisition loan a loan to a corporation if, within 30 days of the date of the loan, employer securities are transferred to the plan in an amount equal to the proceeds of such loan and such securities are allocable to participant accounts within 1 year of the date of such loan ("immediate allocation loans"); (3) clarifies that the refinancing of a loan to an ESOP after May 23, 1984, will qualify as a securities acquisition loan; and (4) clarifies the definition of securities acquisition loan with respect to loans within a controlled group of corporations.[21]

Back-to-back loans.—The Act clarifies the definition of a securities acquisition loan in the case of a loan to a corporation. The Act provides that a loan to a sponsoring corporation will qualify as a securities acquisition loan if the terms of such loan are substantially similar to the terms of the corresponding exempt loan from the corporation to the ESOP (i.e., a back-to-back loan). In addition, the Act provides that, if the terms of the 2 loans are not substantially similar, the loan to the sponsoring corporation will still qualify as a securities acquisition loan if (1) the corresponding loan to the ESOP provides for more rapid payment of principal or interest than the loan to the sponsoring corporation; (2) the allocations of stock within the ESOP attributable to the difference in payment schedules do not result in discrimination in favor of highly compensated employees; and (3) the total commitment period of the loan to the sponsoring corporation is not more than 7 years.[22]

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[21] Items (1) and (4) are in the technical corrections portion of the 1986 Act.

The 7-year limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by one or more lenders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan. If the total commitment period of the loan is extended beyond 7 years, then the partial exclusion will apply for the first 7 years of the loan only.[23]

The 7-year limitation on the term of the loan does not apply to loans directly from a commercial lender to an ESOP or to back-to-back loans if the terms of the loans are substantially similar. For example, assume a bank makes a loan to employer X with a term of 10 years and employer X in turn makes a loan to its ESOP. If the terms of the two loans are substantially similar, then the partial interest exclusion is available for the entire 10-year commitment period of the loan. Similarly, the partial interest exclusion applies for the entire commitment period of the loan if the loan is made directly from the bank to the ESOP.

Immediate allocation loans.—The Act extends the definition of "securities acquisition loan" to include certain loans to a corporation which are used by the corporation to purchase employer securities that are immediately allocated to employees' accounts. Thus, the partial exclusion is available with respect to interest paid on a loan to a corporation to the extent that (1) within 30 days of the date of the loan, employer securities are transferred to the ESOP in an amount equal to the proceeds of the loan, (2) such contributions are allocable to accounts of plan participants within 1 year of the date of the loan, and (3) the total commitment period of the loan does not exceed 7 years. In general, the date of a loan is the date interest begins to accrue on the loan.

As in the case of other loans to which the 7-year limitation applies, the limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by 1 or more lenders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan. If the total commitment period of the loan is extended beyond 7 years, then the partial exclusion will continue to apply for the first 7 years of the loan.[24]

Refinancings.—The Act clarifies that the refinancing of a loan to an ESOP (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar) after

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[22] This provision is contained in the technical corrections provisions of the Act (sec. 1854(c)).

[23] A technical correction may be needed so that the statute reflects this intent.

[24] A technical correction may be needed so that the statute reflects this intent.

May 23, 1984, will qualify as a securities acquisition loan provided that (1) the original loan met the requirements of section 133(b)(1); (2) the original loan was used to acquire employer securities after May 23, 1984; and (3) the total commitment period of the loan does not exceed the greater of the original commitment period of the original loan or 7 years.[25] The limitation on the commitment period of refinancings of immediate allocation loans and back-to-back loans which have terms that are not substantially similar is described above.

If a securities acquisition loan (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar) is refinanced and as a result the total commitment period exceeds the greater of the original commitment period or 7 years, then the partial exclusion will continue to apply, but only for interest paid during the first 7 years of the commitment period or the original commitment period, whichever is greater. For example, if an otherwise qualified securities acquisition loan to an ESOP with an original commitment period of 5 years is refinanced and the commitment period is extended for 2 years (for a total commitment period of 7 years), the partial exclusion will apply for interest paid during the entire 7 years of the loan.

However, under the Act, if the terms of the back-to-back loans are no longer substantially similar as a result of the refinancing, the partial exclusion is available only for interest paid during the first 7 years of the loan.

All refinancings, including refinancings of back-to-back loans which are not substantially similar, are required to comply with section 4975.

Controlled group loans.—The Act clarifies that, although a securities acquisition loan may not originate with any member of the controlled group, it may be held by any member of the controlled group. However, during any such time that a securities acquisition loan is held by a member of the controlled group, any interest received with respect to such loan during such period will not qualify for the exclusion provided under section 133.

Eligible lenders.—Under the Act, a lender eligible for the interest exclusion is amended to include a regulated investment company (as defined in sec. 851). Congress intended that the tax treatment accorded such income be permitted to "flow through" to shareholders of the regulated investment company under rules analogous to the treatment of interest paid on certain governmental obligations as described in section 103(a).

In determining whether a regulated investment company qualifies to pay exempt-interest dividends, ½ of the outstanding balance of such securities acquisition loans held by a regulated investment company is treated as obligations described in section 103(a)(1). One-half of the interest on such securities acquisition loans are treated as interest excludable under section 103(a) for purposes of determining the amount of exempt-interest dividends that the regulated investment company may pay.

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[25] A technical correction may be needed so that the statute reflects this intent. Such a technical correction was included in the versions of H.Con.Res. 395 that passed the House and Senate in the 99th Congress.

The written notice of designation requirements applicable to exempt-interest dividends applies to dividends attributable to securities acquisition loans. Congress intended, however, that the regulated investment company include in such notice an explanation to shareholders that this income is partially excludable from tax because the interest thereon is utilized to repay a loan structured to acquire employer stock for employees through an employee stock ownership plan.

It is intended that a regulated investment company that is otherwise fully invested in ESOP obligations will be permitted to pay out exempt-interest obligations despite having certain amounts of cash or other assets on hand at the end of a taxable quarter, and expects that the Secretary will promulgate appropriate regulations in this regard.

Because only 50 percent of the interest income from ESOP loans is exempt from tax, Congress believed that, for this purpose, it may be appropriate for a mutual fund to have 2 classes of stock, 1 of which pays exempt-interest dividends and the other of which pays taxable dividends.[26] Such allocation is to be reflected in the notice of designation. Any such 2-class arrangement is not subject to the rules of section 654 (relating to series funds) because there will not be segregated portfolios of assets.

Effective Dates

Estate tax deduction for sales to an ESOP

The provision relating to the deduction of 50 percent of the proceeds of a qualified sale from the gross estate (including IRS Notice 87-13) is effective for sales after October 22, 1986, and before January 1, 1992, by the executor of an estate required to file a return (including extensions of time) after October 22, 1986.

Deduction for dividends paid on employer securities

The provision relating to the deductibility of dividends is effective for taxable years beginning after October 22, 1986.

Partial exclusion of interest earned on ESOP loans

The provision relating to the availability of the section 133 interest exclusion in the case of back-to-back loans the terms of which are not substantially similar and controlled group loans are effective as if included in DEFRA, i.e., they are effective with respect to loans made after July 18, 1984, and used to acquire employer securities after such date.

The modification made by the Act with respect to immediate allocation loans is effective for loans incurred after October 22, 1986.

The provision that makes a regulated investment company a lender eligible for the interest exclusion under section 133 is effective with respect to loans used to acquire employer securities after October 22, 1986, including loans that are refinancings of loans used to acquire employer securities before such date if such loans were used to acquire employer securities after May 23, 1984.

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[26] Rev. Rul. 74-177, 1974-1 C.B. 165.

The refinancing provision is effective with respect to loans used to refinance a loan which met the requirements of section 133 and which was used to acquire employer securities after May 23, 1984.[27]

Revenue Effect of ESOP Provisions

The provisions of the Act relating to ESOPs are estimated to increase fiscal year budget receipts by $1,013 million in 1987, $879 million in 1988, $221 million in 1989, and $51 million in 1990, and to decrease fiscal year budget receipts by $40 million in 1991.

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[27] A technical correction may be needed so that the statute reflects this intent.

TITLE XII—FOREIGN TAX PROVISIONS

A. Foreign Tax Credit (Secs. 1201 through 1205 of the Act and secs. 864, 901, 902, 904, 954, 960, and 6038 of the Code)[1]

Prior Law

In general

The United States taxes U.S. persons on their worldwide income, including their foreign income. Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned, and again by the United States. The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. tax on their foreign income by the foreign income taxes they pay on that income.

The United States allows a foreign tax credit for foreign taxes paid on income derived from direct operations (conducted, for example, through a branch office) or passive investments in a foreign country. The United States also allows a credit with respect to dividends received from foreign subsidiary corporations out of earnings that have been subject to foreign taxes. The latter credit, which is discussed in more detail below, is called a deemed-paid credit or an indirect credit.

Creditability rules and withholding taxes on interest

The foreign tax credit is available only for income, war profits, and excess profits taxes paid to a foreign country or a U.S. possession and for certain taxes imposed in lieu of them (Code secs. 901 and 903). Other foreign levies generally are treated as deductible expenses only. To be creditable, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, whatever the foreign government that imposes it may call it.[2] To be considered an income tax, a foreign levy must be directed at the taxpayer's net gain.[3]

Treasury regulations promulgated under Code sections 901 and 903 provide detailed rules for determining whether a foreign levy is creditable (Treas. Reg. secs. 1.901-1 through 1.901-4 and 1.903-1). In general, a foreign levy is creditable only if the levy is a tax and its predominant character is that of an income tax in the U.S. sense. A levy is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country such as the right to extract petroleum owned by the foreign country. The predominant character of a levy is that of an income tax in the U.S. sense if the levy is likely to reach net gain in the normal circumstances in which it applies and the levy is not conditioned on the availability of a foreign tax credit in another country (a levy that is so conditioned is referred to as a "soak-up" tax).

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[1] For legislative background of the provisions, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 601-04; H.Rep. 99-426, pp. 329-58; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 901-05; S.Rep. 99-313, pp. 293-327; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 561-94 (Conference Report).

[2] *Biddle* v. *Commissioner*, 302 U.S. 573 (1938).

[3] *Bank of America National T. & S. Association* v. *United States*, 459 F.2d 513 (Ct. Cl. 1972).

Taxpayers who are subject to a foreign levy and also receive a specific economic benefit from the levying country are referred to as dual capacity taxpayers under the regulations. Dual capacity taxpayers may obtain a credit only for that portion of the foreign levy that they can establish was not compensation for the specific economic benefit received. A specific economic benefit is any economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the levying country, or, if there is no such generally imposed income tax, any economic benefit that is not made available on substantially the same terms to the population of the country in general. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls; or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

A foreign levy is a creditable tax "in lieu of" an income tax under the regulations only if the levy is a tax and is a substitute for, rather than an addition to, a generally imposed income tax. A foreign levy may satisfy the substitution requirement only to the extent that it is not a soak-up tax.

The regulations generally test the creditability of gross withholding taxes on interest under the "in lieu of" creditability rules of section 903 rather than under the general creditability rules of section 901. Such withholding taxes generally were tested for creditability under section 901 under prior regulations.

An earlier version of the regulation governing "in lieu of" taxes (Temp. Treas. Reg. sec. 4.903-1, T.D. 7739, filed November 12, 1980) required that a foreign levy be comparable in amount to the amount that would have been paid on the income involved had the general income tax of the levying country (or U.S. possession) applied to that income. The Treasury Department omitted the comparability rule from the final regulations after concluding that the statutory language of section 903 probably did not grant the IRS sufficient authority to promulgate such a rule.

The foreign tax credit for taxes on foreign oil related income, by contrast, is limited by a comparability rule (Code sec. 907(b)). Under this comparability rule, a foreign tax on oil related income is noncreditable to the extent that the Secretary determines that the foreign law imposing the tax is structured, or in fact operates, so that the amount of tax imposed with respect to foreign oil related income will generally be materially greater, over a reasonable period of time, than the amount generally imposed on income that is neither foreign oil related income nor foreign oil and gas extraction income.

Treasury regulations allow a credit only for that amount of an income tax or "in lieu of" tax that is paid to a foreign country by the taxpayer. The Treasury regulations provide that the "taxpayer" is the person upon whom foreign law imposes legal liability for a tax. However, a tax is considered paid by the taxpayer even if another party to a transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's liability for the tax (Treas. Reg. sec. 1.901-2(f)(2)(i)). Foreign borrowers frequently pay interest on loans from U.S. lenders "net" of income taxes. That is, the borrowers promise the lenders a certain after-foreign tax interest rate on the loans and agree to assume the lenders' liability for any foreign taxes imposed. The borrower may pay the taxes directly, pay additional interest to the lender equal to the tax the lender must pay, or reimburse the lender directly for the tax the lender pays. Foreign taxes paid by foreign borrowers pursuant to such arrangements are income to the U.S. lenders, and, in general, under the regulations, are creditable in full by the U.S. lenders: the taxes are considered paid by the lenders notwithstanding that the foreign borrowers agree to pay them, provided that the levying country does not refund or otherwise forgive the taxes. However, in certain cases where the foreign borrower is a foreign government or is owned by a foreign government, prior and present law may be unclear regarding whether foreign taxes are creditable in full by the U.S. lender.

Under the Treasury regulations on creditability, a tax is not "paid" to a foreign country to the extent that it is reasonably certain to be refunded, credited, rebated, abated, or forgiven (Treas. Reg. sec. 1.901-2(e)(2)). To encourage foreign lenders to lend to their residents, some countries have attempted to subsidize foreign loans to their residents by rebating to their residents, directly or indirectly, all or a portion of the withholding taxes that the countries impose on the interest paid on loans from foreign lenders. Since the taxes are not formally rebated to the lenders, some U.S. lenders argue that they have "paid" the taxes and, therefore, should be granted foreign tax credits for them. The regulations disallow foreign tax credits in these cases, however. Under the regulations, a tax is not "paid" to a foreign country if it is used directly or indirectly as a subsidy to the taxpayer or certain persons who are related to the taxpayer or engaged in transactions with the taxpayer (Treas. Reg. sec. 1.901-2(e)(3)).

Foreign tax credit limitation

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. income, only a taxpayer's U.S. tax on its foreign income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned in the United States.

The tax law imposes a limitation (first enacted in 1921) on the amount of foreign tax credits that can be claimed in a year that prevents a taxpayer from using foreign tax credits to offset U.S. tax on U.S. income. This limitation generally is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide taxable income (U.S. and foreign taxable income combined) between its U.S. and foreign taxable income. The ratio of the taxpayer's foreign taxable income to its worldwide taxable income is multiplied by the taxpayer's total pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign income and, thus, the upper limit on the foreign tax credit for the year.

Overall and per country limitations

Historically, the foreign tax credit limitation has been determined on the basis of total foreign income (an "overall" limitation or method), foreign income earned in a particular country (a "per country" limitation or method), or both.

Under an overall method, the taxpayer adds up its net income and net losses from all sources outside the United States and allocates its pre-credit U.S. tax based on the total. An overall method permits "averaging" for limitation purposes of the income and losses generated in, and the taxes paid to, the various foreign countries in which a taxpayer operates and other income and losses sourced outside the United States. An overall method also permits averaging of tax rates applied to different types of income.

Under a per country method, the taxpayer calculates the foreign tax credit limitation separately for each country in which it earns income. The foreign income taken into account in each calculation is the foreign income derived from the foreign country for which the limitation is being determined. Thus, a per country limitation prevents the use of taxes imposed by one country to reduce U.S. tax on income arising elsewhere. Otherwise, a per country limitation is calculated in basically the same manner as an overall limitation.

From 1921 until 1932, an overall limitation was in effect. Between 1932 and 1954, foreign tax credits were limited to the lesser of the overall or per country limitation amount. In 1954, Congress amended the law to allow only a per country limitation. From 1960 to 1975, Congress permitted taxpayers to elect between an overall and a per country method. Since 1976, an overall limitation has been mandatory.

The per country limitation rules of prior law permitted a taxpayer first to use the entire amount of a net loss incurred in any foreign country to reduce its U.S. taxable income. The taxpayer received a second tax benefit when in a later year, it earned income in the loss country and that country imposed tax on the income at a rate higher than the U.S. rate and had no net operating loss carryforward provision. A full foreign tax credit was allowed for that tax, eliminating the U.S. tax on the income, even though the earlier loss had reduced U.S. taxable income and, thus, U.S. tax, also. Congress repealed the per country limitation and enacted the overall foreign loss recapture rule (discussed below under "*Foreign losses*") in 1976 to eliminate this double tax benefit.

Separate limitations

Under present and prior law, the overall foreign tax credit limitation is calculated separately for DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income (sec. 904(d)). Also, a special limitation applies to the credit for taxes imposed on oil and gas extraction income (sec. 907(a)). Under prior law, the overall foreign tax credit limitation was also calculated separately for passive interest income.

In general, prior law's separate limitation for passive interest income applied to any interest other than the following: interest derived from any transaction which was directly related to the active conduct of a trade or business in a foreign country or a U.S. possession; interest derived in the conduct of a banking, financing, or similar business; or interest received on obligations acquired as a result of the disposition of a trade or business actively conducted in a foreign country or U.S. possession or as a result of the disposition of stock or obligations of a corporation in which the taxpayer owned at least 10 percent of the voting stock.

The separate limitation for passive interest generally did not apply to interest received from a corporation in which the taxpayer (or one or more includible corporations in an affiliated group of which the taxpayer was a member) owned, directly or indirectly, at least 10 percent of the voting stock. However, under the Tax Reform Act of 1984, the separate limitation did apply to subpart F and foreign personal holding company inclusions of, and dividends and interest received by, a U.S. person that were attributable to separate limitation interest income of a 10-percent U.S.-owned foreign corporation or a regulated investment company.

Under the special limitation for oil and gas extraction income, otherwise creditable amounts claimed as taxes paid on foreign oil and gas extraction income of a U.S. company may be credited only to the extent that they do not exceed the highest U.S. corporate tax rate multiplied by the amount of such extraction income. Payments in excess of this limitation generally may be carried back and forward and credited against the U.S. tax otherwise due on extraction income earned in the carryback and carryforward years.

A separate or special limitation generally is applied to a category of income for one of three reasons: the income's source (foreign or U.S.) can be manipulated; the income typically bears little or no foreign tax; or the income often bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income. Applying a separate limitation to a category of income prevents the use of foreign taxes imposed on one category of income to reduce the U.S. tax on other categories of income.

For example, under the separate limitation for passive interest, high foreign taxes paid on manufacturing income generally did not reduce the U.S. tax on interest income that was lightly taxed abroad. Similarly, under the special limitation for oil and gas extraction income, foreign levies on oil and gas extraction income of a corporation, to the extent that they exceed the highest U.S. tax that can apply to such income, cannot reduce the U.S. tax on lightly taxed, nonextraction income. Separate limitations help to preserve the U.S. tax on foreign income that frequently bears little or no foreign tax while at the same time ensuring that double taxation is relieved with respect to all categories of income.

Under prior law, some categories of foreign income, such as passive income, that are relatively manipulable with respect to source and that tend to be lightly taxed abroad were not generally subject to separate limitations. Passive interest income, as already indicated, *was* subject to a separate limitation. An example of passive income not subject to a separate limitation under prior law is dividends paid on portfolio stock investments. Just as the source of passive interest income can be shifted by making an investment in a foreign bank rather than in a U.S. bank, the source of portfolio dividend income can be shifted by buying stock of a foreign corporation rather than stock of a U.S. corporation. Under prior law, a multinational entity could, for example, cross-credit high foreign taxes paid on foreign manufacturing income against portfolio dividend income bearing little or no foreign tax. Similarly, the absence of applicable separate limitations under prior law permitted a multinational entity to average the foreign tax rates on foreign manufacturing income earned in a high tax country and shipping or financial services income that no foreign country taxed or that was subject to little foreign tax.

Prior law also allowed a U.S. lender to use foreign tax credits granted for high foreign withholding taxes on interest to eliminate not only the lender's U.S. tax liability on the net interest income from the associated loans, but also the lender's U.S. tax liability on other income it earned from the same foreign country or from other sources outside the United States.

Deemed-paid credit

U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. This is the "deemed-paid" or "indirect" foreign tax credit.

Earnings and profits of a foreign corporation are generally not subject to U.S. tax as dividend income of a U.S. shareholder until repatriated through an actual dividend distribution. However, the rules of subpart F of the Code (discussed further below) treat certain undistributed earnings and profits of a controlled foreign corporation as a current income inclusion of U.S. shareholders who own 10 percent or more of the voting stock (taking into account attribution rules). A deemed-paid credit is also generally available to the U.S. shareholder with respect to such inclusions.[4]

In the case of an actual dividend distribution, the share of foreign tax paid by the foreign corporation that was eligible for the indirect credit was based under prior law on the share of that corporation's accumulated profits that was repatriated as a dividend to the U.S. corporate shareholder. Foreign taxes paid for a particular year were eligible for the indirect credit only to the extent that there were accumulated profits for that year and then only in proportion to the share of such accumulated profits that was attributed to the dividend distribution. Distributions were considered made first out of the most recently accumulated profits of the distributing corporation. Distributions made during the first 60 days of a taxable year were treated as paid out of the prior year's accumulated profits. A 1974 IRS ruling states that a foreign corporation's deficit in earnings and profits in any year reduces the most recently accumulated earnings and profits of prior years for purposes of matching prior years' foreign taxes with accumulated profits. Rev. Rul. 74-550, 1974-2 C.B. 209.[5]

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[4] Unlike the deemed-paid credit for actual dividend distributions, the deemed-paid credit for subpart F inclusions can be available to individual shareholders in certain circumstances if an election is made.

In the case of an income inclusion under subpart F, foreign taxes paid by the foreign corporation for the taxable year were eligible for the indirect credit under prior law only in proportion to the share of the controlled foreign corporation's earnings and profits of the year that was attributed to the subpart F inclusion.

For either an actual distribution or a subpart F inclusion, the amount of foreign tax eligible for the indirect credit is computed under present and prior law as a fraction of the foreign tax paid by the foreign corporation. The numerator of the fraction is the U.S. corporate shareholder's actual dividend or subpart F inclusion income from the foreign corporation. Under prior law, the denominator was the foreign after-tax accumulated profits (in the case of an actual dividend) or earnings and profits (in the case of a subpart F inclusion) attributed to the taxable year of the foreign tax. (Under present and prior law, the amount of foreign tax thus eligible for the indirect credit is also "grossed-up" and included in the U.S. corporate shareholder's income to treat the shareholder as if it had received its proportionate share of pre-tax profits and paid its proportionate share of foreign tax).[6]

Under this formula for computing the indirect credit, for any given dividend amount in the numerator of the fraction, a greater amount of profits in the denominator of the fraction produces a smaller amount of foreign taxes allowed as a credit.

Under prior law, both accumulated profits of a foreign corporation in the case of actual dividend distributions [7] and earnings and profits of the foreign corporation in the case of a subpart F inclusion were generally calculated in accordance with the principles governing the calculation of earnings and profits for U.S. tax purposes.

However, accumulated profits as calculated for purposes of the indirect credit with respect to actual distributions, and earnings and profits as calculated for purposes of the indirect credit with respect to subpart F inclusions could differ in several respects. For example, under present and prior law, the subpart F rules (which Treasury regulations allowed a U.S. corporate shareholder to elect to apply to actual distributions from a controlled foreign corporation under prior law) do not require adjustment to U.S. financial and tax accounting principles if the adjustment is not "material". In addition, different foreign currency translation rules for actual and for subpart F deemed distributions were mandatory under prior law.

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[5] *Compare Champion International Corp.*, 81 T.C. 424, 442 (1983); *Pacific Gamble Robinson Co.* v. *United States*, 62-1 USTC Para. 9160 (W.D. Wash. 1961).

[6] For example, assume a foreign subsidiary earns $100 of income on which it pays $30 of foreign income tax. If a $35 dividend were paid (or if there were a $35 income inclusion under subpart F) out of the $70 of after-tax earnings, the U.S. shareholder would have a $15 indirect foreign tax credit (35/70 x $30) and $50 of income ($35 + $15). The "gross-up" prevents the U.S. corporate taxpayer from effectively obtaining a deduction as well as a credit for foreign taxes, since the amount of the actual distribution or subpart F inclusion reflects only after-foreign tax profits.

[7] *Steel Improvement & Forge Co.*, 36 T.C. 265 (1961), *rev'd on another issue*, 314 F.2d 96 (6th Cir. 1963); Rev. Rul. 63-6, 1963-1 C.B. 126; Treas. Reg. sec. 1.902-1(e); *see H.H. Robertson Co.*, 59 T.C. 56 (1972), *aff'd in unpublished opinion* (3d Cir. July 24, 1974).

In the case of an actual dividend distribution, the first-tier foreign corporation making the distribution is generally deemed under present and prior law to have paid a proportionate share of the foreign taxes paid by a second-tier foreign corporation of which it owns at least 10 percent of the voting stock, and the same principle applies between a second and a third-tier foreign corporation; provided (in the case of a second or third-tier foreign corporation) that the product of the percentage ownership at each level equals at least 5 percent. Foreign taxes paid below the third-tier are not eligible for the deemed-paid credit.

Subpart F inclusions are deemed included directly in the income of the U.S. shareholder. For example, a subpart F inclusion from a second- or third-tier foreign subsidiary is not treated as passing through any upper-tier corporation; rather, it is an inclusion directly from the lower-tier subsidiary. Thus, the foreign taxes and earnings and profits of that subsidiary are undiluted by and are not combined with those of any upper-tier company in determining the deemed-paid credit. The credit is not available, however, for inclusions from subsidiaries below the third tier. Percentage ownership requirements, similar to those applicable in the case of actual dividends, apply in order for inclusions from lower-tier subsidiaries to qualify for the deemed-paid credit.

For purposes of the excess credit carryback and carryover provisions, foreign taxes eligible for the deemed-paid credit are considered paid in the year the U.S. corporation includes the related dividend in income, regardless of when the taxes were paid to the foreign country.

Foreign losses

If a taxpayer's foreign losses exceed its foreign income, the excess ("overall foreign loss") may reduce the taxpayer's U.S. source taxable income and, hence, its U.S. tax. To eliminate a double benefit (that is, the reduction of U.S. tax just noted and, later, full allowance of a foreign tax credit with respect to foreign income), the overall foreign loss recapture rule was enacted in 1976. Under this rule, a portion of foreign taxable income earned after an overall foreign loss year is treated as U.S. taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (Code sec. 904(f)). Foreign taxable income up to the amount of the overall foreign loss may be so treated. However, unless the taxpayer elects a higher percentage, no more than 50 percent of the foreign taxable income earned in any particular year is treated as U.S. taxable income. The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an overall foreign loss year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

Foreign oil and gas extraction losses incurred abroad are treated separately from other foreign losses. Foreign extraction losses first reduce other foreign extraction income. If a taxpayer's foreign extraction losses exceed its foreign extraction income, the excess ("overall foreign extraction loss") first reduces the taxpayer's other foreign taxable income, then the taxpayer's U.S. taxable income. Overall foreign extraction losses are subject to a separate loss recapture rule (sec. 907(c)(4)) that operates in substantially the same manner as the general foreign loss recapture rule. Under the overall foreign extraction loss recapture rule, a portion of foreign extraction income earned after an overall extraction loss year is treated as foreign income other than foreign extraction income for foreign tax credit purposes. If an overall foreign loss includes an overall foreign extraction loss, both recapture rules will apply in a later year in which the taxpayer earns extraction income. The extraction income will first be recharacterized as U.S. income under the foreign loss recapture rule. Any extraction income not so recharacterized will then be subject to the overall foreign extraction loss recapture rule.

Under prior law, the Code did not specifically address the question whether, for foreign tax credit purposes, a loss in a separate foreign tax credit limitation "basket" first offset foreign taxable income not subject to that particular separate limitation, or immediately offset U.S. taxable income. Similarly, the Code was unclear regarding whether a loss in the overall limitation basket first offset foreign taxable income subject to the separate limitations, or immediately offset U.S. taxable income. If such losses offset U.S. taxable income first, then the overall foreign loss recapture rule presumably would have to have applied separately to overall limitation income and to each separate limitation income basket. The Code did not specifically indicate that the overall foreign loss recapture rule was to be applied in this manner. However, proposed regulations (Treas. Reg. secs. 1.904(f)-1 through -6) issued by the IRS in January 1986 took the position that the overall foreign loss recapture rule was to apply separately to each income basket.

Congress was informed that many taxpayers took the position that separate limitation and overall limitation losses immediately offset U.S. taxable income. Under this approach, foreign tax credits effectively could reduce U.S. tax on U.S. income. As indicated above, this result would violate a basic premise of the credit: that it should reduce the U.S. tax on foreign income only. Assume, for example, that a corporation had $100 of U.S. taxable income and $100 of foreign taxable income, the latter consisting of $200 of interest income subject to prior law's separate limitation for interest and a $100 aggregate business loss in the income categories subject to the overall limitation. The corporation paid $92 of foreign tax on the interest income. The U.S. tax on $100 of U.S. source corporate income was $46 under prior law rates. The pre-credit U.S. tax and the foreign tax credit limitation, with respect to $100 of foreign source taxable income, was also $46. If the corporation in this example had allocated its $100 foreign business loss against its $100 of U.S. taxable income, rather than against its $200 of foreign interest income, the corporation's separate limitation interest income for foreign tax credit purposes would have been $200 rather than $100. This allocation would have increased its separate foreign tax credit limitation for interest from $46 to $92. The larger limitation, in effect, would have let the corporation reduce the U.S. tax on its U.S. taxable income (and its overall post-credit U.S. tax liability for the year) from $46 to zero. Under this interpretation of prior law, the $46 of foregone U.S. tax might have been recaptured in later years under the foreign loss recapture rule if the corporation earned overall limitation income in later years; however, the U.S. Treasury was at risk that no such income would be earned in later years or, if it was, that no U.S. tax would be due when such income was earned.

U.S. losses

Under present and prior law, an overall U.S. loss reduces a taxpayer's foreign source income, just as an overall foreign loss reduces a taxpayer's U.S. source income. The U.S. loss reduces the taxpayer's U.S. tax liability and, through the application of the loss against foreign income, the foreign tax credit limitation is correspondingly reduced.

If a taxpayer earns foreign income in more than one foreign tax credit limitation "basket"—for example, income subject to the overall limitation and income subject to a separate limitation—any U.S. loss of the taxpayer incurred in the same year must be allocated between or among the different income baskets for foreign tax credit limitation purposes. Under a 1982 revenue ruling (Rev. Rul. 82-215, 1982-2 C.B. 153), the loss in effect was allocated first to any income basket that attracted no foreign tax, that is, an income basket that had no foreign tax credits available and, therefore, absent allocation of the loss, would have borne full U.S. tax. Under an earlier revenue ruling (Rev. Rul. 81-50, 1981-1 C.B. 410), which was revoked by the one just discussed, a U.S. loss was allocated among foreign income baskets on a different basis: the loss was allocated pro rata among the income baskets.

Subpart F rules

In general, no current U.S. tax applies to the foreign income of a foreign corporation, and a U.S. investor in a foreign corporation is taxed only when income is distributed to him. However, the deferral of U.S. tax on the income of U.S.-owned foreign corporations does not apply to certain kinds of income. Under the Code's subpart F rules (Code secs. 951-64), when a U.S.-controlled foreign corporation earns tax haven income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently.

Subpart F income includes foreign personal holding company income, consisting generally of several types of passive income. Subpart F income also includes foreign base company shipping income which, under prior law, excluded shipping income reinvested in shipping operations. (The subpart F rules are discussed in greater detail at C., below in connection with changes to those rules made by the Act.)

Reasons for Change

Separate foreign tax credit limitations

The purpose of the foreign tax credit is to reduce international double taxation. Under the credit system, the United States reserves the right to collect full U.S. income tax on U.S. persons' foreign income, less any foreign income taxes imposed on that income. Under the overall foreign tax credit limitation, however, the

United States sometimes collects little or no residual U.S. tax—after aggregate foreign taxes are credited—on certain types of income that are themselves taxed abroad at below the U.S. rate. This failure to collect taxes arises because the overall limitation permits a cross-crediting of taxes, sometimes referred to as "averaging." The overall limitation allows taxpayers to credit high foreign taxes paid on one stream of income against the residual U.S. tax otherwise due on other, lightly taxed foreign income.

In general, Congress believed that the overall limitation was consistent with the integrated nature of U.S. multinational operations abroad. Congress believed that the averaging of foreign tax rates generally should continue to be allowed. However, Congress recognized that, in certain situations, cross-crediting should not be permitted when it would distort the purpose of the foreign tax credit limitation. Congress believed that, in some cases, the ability of U.S. persons to average foreign tax rates for foreign tax credit limitation purposes and thereby reduce or eliminate the residual U.S. tax on their foreign income had undesirable consequences. U.S. taxpayers with excess foreign tax credits have an incentive at the margin to place new investments abroad rather than in the United States when the income that those investments will generate will be taxed abroad at below the U.S. rate and the excess credits will be available to reduce or eliminate the U.S. tax on the income. This incentive is of particular concern in the case of investments that can quickly and easily be made in foreign countries rather than at home, for example, portfolio investments in stock in publicly traded companies. Congress was concerned that the incentive to choose foreign over U.S. investment would be more pronounced in the future as a result of the Act's tax rate reductions: lower U.S. taxes (relative to foreign tax rates) cause many taxpayers to have more excess credits and more taxpayers to operate in excess credit positions.

The cross-crediting allowed under prior law also had the unintended effect of reducing the pressure on foreign countries to lower their tax rates.

Congress was also concerned that, absent modification of the foreign tax credit limitation rules, the cross-crediting opportunities that prior law provided, coupled with other features of the Act, could have tilted the relative balance of U.S. tax rules favoring foreign investment and U.S. tax rules favoring U.S. investment in favor of foreign investment. Overall, the Act is estimated to increase substantially the U.S. tax on the aggregate U.S. source income of U.S. corporations, but not to increase significantly the U.S. tax on the aggregate foreign source income of U.S. corporations. Reducing cross-crediting opportunities (along with some of the Act's other foreign tax provisions) attenuates this disparity somewhat.

As indicated above, under present and prior law, certain income is subject to separate foreign tax credit limitations to prevent cross-crediting involving such income. Separate foreign tax credit limitations are provided for DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income. Prior law also contained a separate limitation for passive interest. In addition, under present and prior law, a special limitation applies to oil and gas extraction income. DISC dividends are subject to a separate limitation because they generally bear no foreign tax. Similarly, FSC income is treated separately for limitation purposes because few foreign countries tax it substantially. A separate limitation applied to passive interest because U.S. taxpayers could shift the source of passive interest from the United States to foreign countries by, for example, withdrawing funds from U.S. banks and depositing them in foreign banks, and could secure a low rate of foreign tax on interest by making interest-bearing investments in foreign countries that either unilaterally, or pursuant to an income tax treaty with the United States, imposed little or no tax on interest paid to a person not engaged in a trade or business in that country. Foreign taxes on oil and gas extraction income are often abnormally high: the special limitation applicable to such income prevents the cross-crediting of those high taxes against the U.S. tax on other, lightly taxed foreign income.

Several categories of income that were not previously subject to separate limitations present cross-crediting problems similar to those presented by DISC dividends, FSC income, passive interest, and extraction income: that is, they frequently bear little foreign tax or abnormally high foreign tax, or are relatively manipulable as to source (U.S. or foreign). In light of the general concerns expressed above and the specific problems discussed immediately below, Congress decided that passive income, financial services income, shipping income, high withholding tax interest, and dividends from noncontrolled section 902 corporations should be subject to separate foreign tax credit limitations.

Passive income

In general, passive income earned abroad by U.S. persons (for example, portfolio stock dividends, passive rents and royalties, passive commodity trading gains, gains from sales of stock and securities, and annuities) tends to bear little or no foreign tax. Also, many forms of passive income are manipulable as to source. The incentive at the margin to place new investments abroad rather than at home, if the taxpayer has excess foreign tax credits that can be used to shelter additional foreign income from U.S. tax, is of particular concern in the case of passive investments, which often can quickly or easily be made in low or no tax foreign countries.

Financial services income

Income earned in a financial services business, by its nature, is relatively movable; it may sometimes be shifted to low tax jurisdictions where excess credits from unrelated high tax business operations could, under prior foreign tax credit limitation rules, shelter it from U.S. tax. As a practical matter, it is sometimes not possible to differentiate passive investment from bona fide financial services activity. The exception from separate limitation treatment under prior law for interest derived in the conduct of a banking, financing, or similar business gave manufacturing companies with substantial excess credits, for example, an incentive to establish or acquire banking- (or other financial services-) type entities in low tax jurisdictions to generate low tax income to be sheltered by those excess credits. Congress was concerned that the foreign tax credit rules created too great an incentive for businesses to divert their resources into such entities abroad for tax purposes.

On the other hand, Congress believed that active banks, insurance companies, finance companies, and similar businesses, which, under the overall limitation of prior law, could credit foreign taxes on one type of financial income against U.S. tax liability on another type of financial income, should retain that ability. The cross-crediting Congress sought to curtail was primarily that between banking, insurance, financing, and similar income and income unrelated to financial services.

Shipping income

Congress also understood that shipping income frequently is not taxed by any foreign country or is subject to very limited foreign tax. Under the overall limitation of prior law, U.S. multinational entities with excess foreign tax credits from other business activities could earn such shipping income free of U.S. tax as well: their excess credits could shelter the shipping income from U.S. tax.

High withholding tax interest

A number of foreign countries, particularly developing countries, impose gross withholding taxes on interest earned by nonresident lenders that significantly exceed the general income taxes that would be imposed on the associated net interest income were it taxed on a net basis. In the case of U.S. lenders, these gross withholding taxes often far exceed the pre-credit U.S. tax on the net interest income as well. When, under prior law, a gross withholding tax equaled the pre-credit U.S. tax, the U.S. lender paid no U.S. tax on loan proceeds associated with interest subject to the withholding tax under the United States' generally applicable foreign tax credit rules. When a gross withholding tax exceeded the pre-credit U.S. tax, the U.S. lender was subject to a negative rate of U.S. tax on the foreign loan transaction (as other U.S. taxpayers operating abroad sometimes are on other foreign transactions) to the extent that the lender used the excess foreign tax credits to reduce its U.S. tax liability on other income, derived from the same foreign country or from other sources outside the United States, that was subject to little or no foreign tax. Income from domestic loans, by contrast, generally is subject to full U.S. tax. As a result of the foreign tax credit mechanism, the U.S. Treasury, in effect, bore the burden of those high levels of foreign tax on foreign loans.

Congress was concerned, moreover, that the available evidence suggested that the economic burden of high foreign gross withholding taxes on interest falls largely, in the typical situation, on the foreign borrower rather than on the U.S. lender. To the extent that is the case, the prior rules allowing a full foreign tax credit for high foreign taxes on interest paid to U.S. lenders provided an incentive for some U.S. lenders to make foreign loans rather than domestic loans that would otherwise be equally attractive, and to make otherwise uneconomical foreign loans. The higher the applicable foreign tax on interest was, the larger the U.S. lender's foreign tax available for credit was and, thus, the greater the incentive could be. Congress was particularly concerned that foreign countries seeking to attract U.S. capital might have been encouraged by the prior law rules to increase rather than to decrease their gross withholding taxes on interest paid to U.S. persons. According to a January 1985 report in the *Wall Street Journal*, some U.S. bank lenders to Mexico responded negatively after the Mexican Government decided to exempt from a Mexican withholding tax on interest the interest payments made by a Mexican state-owned food distributor to foreign banks.[8] The Mexican Government subsequently withdrew the exemption.[9]

In light of the above, Congress believed that interest received by U.S. persons that bears a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more should be subject to a separate foreign tax credit limitation. Congress subjected such interest to a separate limitation, rather than directly disallowing foreign tax credits for gross interest taxes in excess of net U.S. tax, because some argued that such disallowance could have violated income tax treaties. Congress chose to apply the separate limitation to interest subject to a 5-percent or greater gross-basis tax, instead of to interest taxed on a gross basis at a net rate greater than the net U.S. rate, in the interest of administrative simplicity. The Act's approach may be theoretically inferior to the latter approach, but avoids the necessity of computing the net U.S. tax on particular interest payments to determine allowable foreign tax credits.

Under the rule adopted, high foreign gross basis taxes on interest continue, in many or most cases, through the credit mechanism, effectively to exempt the associated net interest income from U.S. tax. However, such foreign taxes are no longer available to reduce U.S. tax on other, low taxed foreign income of a U.S. person. Applying this rule to high foreign taxes on interest is similar in some respects to the present and prior law treatment of foreign oil and gas extraction taxes, the foreign tax credit for which is limited (in the case of U.S. companies) to the maximum pre-credit U.S. corporate tax payable on the associated extraction income.

The Act applies the separate limitation to all interest recipients, rather than to financial institutions alone, because entities other than financial institutions making high withholding tax loans could receive the same tax advantages under prior law as financial institutions making such loans.

Export financing exceptions

Congress was concerned that the Act might have the effect of reducing the pre-enactment availability of export financing in some cases, which could, in turn, have a negative impact on the volume of exports. Consequently, Congress decided to exempt from the separate limitations for passive and financial services income and high withholding tax interest certain interest derived from financing the exports of the taxpayer or related persons that was not subject to separate limitations under prior law. Prior law separate limitation treatment of export-related income was retained.

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[8] S. K. Witcher, "Foreign Banks Worry Mexican Ruling Could Mean Loss of Tax Credits at Home," *Wall Street Journal*, Jan. 25, 1985, p. 24.

[9] S. Frazier & S. K. Witcher, "Debt-Swap Plan Is Proposed by Mexicans," *Wall Street Journal*, March 15, 1985, p. 29.

Look-through rules

Congress determined that dividends, interest, rents, and royalties from, and subpart F inclusions with respect to, controlled foreign corporations should be subject to the new separate limitations and to the overall limitation in accordance with look-through rules that take into account the income of the controlled foreign corporation itself. In Congress' view, a dividend received by a 10-percent shareholder of a controlled foreign corporation, for example, should not automatically be treated as 100-percent passive income. Look-through rules reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (as through a foreign branch), and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a controlled foreign corporation.

Congress decided to subject interest, rents, and royalties, in particular, to look-through rules because such payments often serve as alternatives to dividends as a means of removing earnings from a controlled foreign corporation or other related person. In addition, Congress believed that interest, rents, and royalties from controlled foreign corporations generally should be treated for look-through purposes like dividends from controlled foreign corporations[10] so that payment of the former would not be discouraged. Interest, rents, and royalties generally are deductible in computing tax liability under foreign countries' tax laws while dividend payments generally are not; thus, in the aggregate, interest, rent, and royalty payments reduce foreign taxes of controlled foreign corporations more than dividend payments do. Under the foreign tax credit system, the payment of interest, rents, and royalties by controlled foreign corporations may, therefore, reserve for the United States more of the pre-credit U.S. tax on these corporations' foreign earnings than the payment of dividends.

Congress thought it desirable to limit the application of the look-through rules and to make their application, where required, as simple as possible for taxpayers and the IRS. To that end, the Act, where feasible, conforms the separate limitation look-through rules with the subpart F rules. No look-through rules generally are applied, for example, in characterizing, for separate limitation purposes, payments from foreign entities in which U.S. persons own a 50-percent or smaller interest. Congress restricted the scope of look-through treatment in this manner, in part, because, as just noted, a primary function of look-through treatment is to make the foreign tax credit limitation treatment of income earned through foreign branches and income earned through foreign subsidiaries more alike by, in effect, treating income earned by a foreign subsidiary as if it were earned directly by its U.S. parent. When the U.S. interest in a foreign entity falls below a majority interest, Congress believed that such entity frequently no longer substantially resembles a branch operation of U.S. persons. Further, the Act's approach recognizes the difficulty that some shareholders in minority

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[10] Absent an applicable look-through rule, interest, dividends, and passive rents and royalties are generally fully subject to the separate limitation for passive income.

U.S.-owned corporations might have encountered in obtaining the additional income and tax information necessary to apply the look-through rules to payments of such corporations.

As discussed in detail at C.1.a., below, the Act repeals subpart F's chain deficit rule (Code sec. 952(d)), modifies subpart F's accumulated deficit rule (Code sec. 952(c)(1) and (2)), and provides for the recapture of subpart F income that is eliminated by current year deficits in nonsubpart F income categories. These subpart F amendments reflect, in part, Congress' conclusion that separate limitation income received by controlled foreign corporations (which is frequently subpart F income also) should not be permanently eliminated by deficits of other controlled foreign corporations, prior year deficits in different income categories, or current year deficits in nonsubpart F income categories. Congress felt that the integrity of the separate limitation for passive income, for example, would be compromised if taxpayers could shelter passive income from U.S. tax, notwithstanding the separate limitation, simply by placing passive investments in controlled foreign corporations with accumulated losses. Preserving separate limitation income (otherwise eliminated by deficits) for foreign tax credit limitation purposes absent the indicated subpart F changes would necessitate more frequent application of the look-through rules to dividends paid by controlled foreign corporations with passive income.

The Act adopts a de minimis exception to the new separate limitations, applicable to income of controlled foreign corporations, so that U.S. shareholders of controlled foreign corporations may avoid the recordkeeping burden of applying the look-through rules to limited amounts of separate limitation income earned by such corporations. The purpose of this de minimis rule, which parallels the subpart F de minimis rule (discussed at C.1.c., below), is to simplify the application of the separate limitations in cases involving controlled foreign corporations.

To avoid creating an incentive for taxpayers to keep, or move, passive income and investments offshore, the Act requires direct allocation in applying the look-through rule for interest. Under the direct allocation approach of the Act, interest payments by a controlled foreign corporation to its U.S. shareholders are separate limitation passive income to those shareholders to the full extent of the foreign corporation's gross passive income.

Dividends from noncontrolled section 902 corporations

Congress concluded that, for several reasons, dividends paid by "non-controlled section 902 corporations" (dividends eligible for the section 902 deemed-paid credit, paid by foreign corporations out of earnings and profits generated when the corporations were not controlled foreign corporations) should be subject to a separate limitation on a corporation-by-corporation basis. First, and most importantly, application of a look-through rule to dividends from noncontrolled section 902 corporations is not appropriate under the view, generally adopted by Congress in connection with this tax reform legislation, that it is frequently appropriate to allow cross-crediting of taxes paid by one unit of a worldwide business against income earned by another unit of that business. In the case of controlled foreign corporations, Congress adhered to this general view, on the theory that in many cases, whether one unit or another of a multinational enterprise is considered to earn income in a business (and whether any particular unit is considered to earn income in one country rather than another) makes little economic difference, so long as the income from that business generally inures to the benefit of the same person. Because of this general view, and because of concerns about the difficulty of administration, Congress declined to adopt the Administration's proposal to reimpose a per-country limitation on the foreign tax credit. In the case of foreign corporations that are not controlled foreign corporations, however, Congress did not believe that there is sufficient identity of interest with U.S. shareholders to treat nonmajority ownership positions as units of a worldwide business. Accordingly, Congress did not believe it is appropriate to allow cross-crediting of taxes from nonmajority interests against income derived from controlling interests or vice versa, or of taxes from one nonmajority interest against income of another nonmajority interest. In rejecting the application of a single separate limitation to all dividends received by a taxpayer from noncontrolled section 902 corporations collectively, Congress was concerned, in addition, that such an approach would permit the cross-crediting of taxes with respect to earnings from foreign companies that were not parts of a single economic unit. Congress believed that a company-by-company limitation, by eliminating the possibility that any of these companies' dividends will be taxed twice, still achieves the goal of the foreign tax credit of preventing double taxation.

Because there is generally a substantive economic difference between income inuring to the benefit of a particular noncontrolled section 902 corporation and income inuring to the benefit of some other entity, administration of a company-by-company limitation is relatively easy. This relative administrative ease arises because substantial adverse ownership interests in a noncontrolled section 902 corporation tend to prevent tax disputes about whether this entity or another entity earned any particular income.

Application of a look-through rule to dividends from noncontrolled section 902 corporations might have been difficult for some shareholders; for example, they may not have ready access to the tax and income information of the foreign corporation which would be needed in applying the look-through rule. Congress believed that the administrative burdens associated with the separate limitation for dividends from noncontrolled section 902 corporations are much less severe than those that would arise if Congress generally required look-through consideration of dividends from foreign corporations no more than 50-percent U.S.-owned. Congress recognized that this corporation-by-corporation approach requires a computation not required under prior law: allocation of expenses to dividends from noncontrolled section 902 corporations on a corporation-by-corporation basis. Congress believed that this additional computation is much easier than the application of a look-through rule to these dividends would be.

Deemed-paid credit

Prior law affected the availability of the deemed-paid credit when a foreign corporation's effective foreign tax rate changed for any reason (for example, where foreign tax rates rose as a result of the end of a "tax holiday" or otherwise or where foreign tax rates declined). It was frequently advantageous under prior law for foreign subsidiaries, where possible, to accumulate their earnings in years in which their effective foreign tax rate was low and distribute their earnings to U.S. parent corporations in years in which their effective foreign tax rate was high, rather than distributing their earnings on an annual basis with more constant dividends. Since, for purposes of computing the foreign taxes attributable to a dividend, the dividend was deemed distributed out of the subsidiary's earnings and profits for the current year first, drawing with it the foreign taxes with respect to those earnings, and then was treated as being derived from each preceding year, the distribution of dividends only in high tax years yielded a higher foreign tax credit than the average foreign taxes actually paid by that foreign subsidiary over a period of years. This result did not and does not occur in the case of a direct branch operation, since all branch income is subject to U.S. tax currently and foreign taxes eligible for the credit are taken into account currently.

Prior law thus provided opportunities for the so-called "rhythm method" of dividend distributions from foreign subsidiaries. For example, suppose a U.S. parent corporation had two foreign subsidiaries and the foreign tax rate for each could be significantly lowered in one year at the cost of an increased rate in the next year, through timing the allowance of deductions and the recognition of income. Matters could be arranged so that the high and low tax years of the subsidiaries alternated, and the U.S. parent corporation took the dividends it needed each year from the particular subsidiary that in that year had a high effective foreign rate.

In addition, when a foreign subsidiary had profits (subject to foreign tax) in some years and deficits in other years and did not distribute all its earnings currently, a portion of the foreign tax may never have been creditable. For example, although there may have been no foreign tax in a year in which a deficit occurred, the foreign law may not have provided for a reduction in the foreign taxes paid in earlier profitable years (that is, the foreign country may not have allowed a loss carryback). In such a case, even if the subsidiary paid out all its net after-tax earnings at the end of the several years, the IRS took the position that less than all the foreign taxes paid over those years could be eligible for the credit. This was because the deficit was in some cases viewed as eliminating accumulated profits for the prior years in which the foreign taxes were paid, thus reducing the total amount of creditable taxes. *See* Rev. Rul. 74-550, 1974-2 C.B. 209. In a branch situation in which foreign income is taxed currently, this loss of foreign tax credits generally would not occur.

Congress recognized that there are difficulties in equating the foreign tax credit results of operation through a subsidiary and a branch, principally because of the deferral that is generally available to a subsidiary. However, Congress believed that in some instances steps to provide more similar results in the two cases were desirable. The Act adopts an approach, on a prospective basis, that computes the deemed-paid foreign tax credit of a U.S. shareholder with reference to the post-effective date accumulated foreign taxes and pool of accumulated earnings and profits (including all earnings and profits of the current year in the pool).

In summary, this pooling approach was intended to have two results. It was intended to alleviate the situation described above in which deemed-paid foreign tax credits were lost as a result of a deficit in a foreign corporation's earnings and profits. More importantly, Congress intended to limit the ability of taxpayers to claim a deemed-paid credit that reflects foreign taxes higher than the average rate over a period of years, by averaging the high tax years and the low tax years of the foreign corporation in determining the foreign taxes attributable to the dividend.

Foreign losses

As indicated already, separate limitations function to reduce the averaging of foreign income and taxes, and the use of excess foreign tax credits, in connection with categories of foreign income that would otherwise pose particularly serious averaging problems. Separate limitations should not allow taxpayers to use losses in separate limitation baskets, or in the overall limitation basket, to reduce U.S. taxable income before foreign taxable income. Congress repealed the per country limitation in 1976 specifically to prevent a net loss incurred in one foreign country from reducing U.S. taxable income before foreign taxable income earned in other foreign countries. As indicated above, using separate limitation losses to reduce U.S. taxable income before foreign taxable income inflates the foreign tax credit limitation, permitting the foreign tax credit to reduce in the loss year, and sometimes permanently, the U.S. tax on U.S. income. Congress decided to make it clear that, for foreign tax credit limitation purposes, both separate limitation and overall limitation losses are to offset taxable income in other foreign income baskets on a pro rata basis before such losses offset U.S. taxable income.

The allocation to other foreign income of a loss in the overall limitation basket, by reducing that other foreign income, reduces the residual U.S. tax otherwise due on that income in the event that it is lightly taxed abroad. The allocation to foreign income subject to the overall limitation of a loss in a separate limitation basket, by reducing the overall limitation income and hence the overall limitation, results in additional excess foreign tax credits in the event that the overall limitation income bears high foreign tax. Congress believed that these effects should be mitigated. The Act accomplishes this by requiring in a year or years following the loss year, when income is earned in the loss basket, a recharacterization of that income as income of the type previously reduced by the loss.

U.S. losses

In the case of a taxpayer with income in more than one foreign income basket, Congress found no sound policy basis for effectively allocating a U.S. loss incurred by the taxpayer in the same year first to any particular income basket. More specifically, Congress found no basis to allocate a U.S. loss to an income basket that attracted no foreign tax and, therefore, absent the loss, would bear full U.S. tax. Such an allocation rule also has the effect of inflating the foreign tax credit limitation applicable to income baskets that do attract foreign tax. Congress believed that a more neutral allocation rule like that of an earlier revenue ruling requiring that a U.S. loss be allocated pro rata among foreign income baskets should be restored. Such a rule for U.S. losses is consistent with the pro rata allocation rule for foreign losses contained in the Act.

Subsidies

As indicated above, a Treasury regulation denies a foreign tax credit for foreign taxes used directly or indirectly as a subsidy to the taxpayer. Absent this rule, the Treasury would, in effect, bear the cost of tax subsidy programs instituted by foreign countries for the direct or indirect benefit of their residents and certain nonresidents who do business with their residents. Congress was informed that some U.S. lenders and other U.S. taxpayers took tax return positions that were inconsistent with this rule. Congress did not believe that foreign tax credits should be allowed for foreign taxes which, while ostensibly borne by a U.S. taxpayer, are effectively rebated by the levying country by means of a government subsidy to the taxpayer, a related party, a party to a transaction with the taxpayer, or a party to a related transaction. To eliminate any uncertainty in this area, Congress believed that the Treasury regulation rule disallowing foreign tax credits for taxes used as a subsidy to the taxpayer should be clarified and codified.

Congress also believed that the rule set forth in *Lederman v. Commissioner*, 6 T.C. 991 (1946), which suggests that payment of foreign tax for foreign tax credit purposes is proved ipso facto by the act of withholding, was subject to abuse. Application of the *Lederman* rule was of particular concern in the context of a net loan, under which the net amount paid to the U.S. payee is unaffected by the amount of tax withheld. In such a case, it is impossible to determine prima facie whether a claimed amount withheld has actually been withheld, since the amount received by the payee remains unchanged. The logic of the *Lederman* rule simply does not apply in such circumstances. Congress concluded that external proof of withholding and payment over should be required to establish the amount of foreign withholding tax paid with respect to foreign source interest income received by U.S. taxpayers.

Explanation of Provisions

1. Overview

The Act subjects passive income, financial services income, and shipping income to separate foreign tax credit limitations. The Act prevents taxpayers from using high foreign taxes paid on other income to reduce or eliminate the residual U.S. tax on these income categories. The separate limitations for financial services and shipping income also prevent taxpayers from using foreign tax credits for high taxes on these types of income to shelter other, lightly taxed foreign income from U.S. tax.

Subject to several modifications and exclusions discussed below, passive income, for this purpose, generally is any income of a kind which would be foreign personal holding company income as defined for purposes of the Code's anti-tax haven (subpart F) rules if earned by a controlled foreign corporation. The separate foreign tax credit limitation for passive income subsumes prior law's separate foreign tax credit limitation for passive interest income. To prevent substantial averaging of foreign taxes and income within the passive "basket," the Act excludes from that basket income bearing relatively high foreign tax.

Income subject to the new separate limitation for financial services income generally includes any nonpassive income derived in the conduct of a banking, financing, or similar business and, with certain additions, any income of a kind which would be insurance income as it is defined for purposes of the Code's anti-tax haven rules. In addition, passive income is subject to the separate limitation for financial services income when received by an entity predominately engaged in the active conduct of a banking, insurance, financing, or similar business.

Income subject to the new separate limitation for shipping income generally is any income of a kind which would be foreign base company shipping income as it is defined for purposes of the Code's anti-tax haven rules.

The Act also subjects to a separate foreign tax credit limitation interest income that is subject to foreign withholding tax of 5 percent or more. Under this rule, U.S. lenders are no longer able to use foreign tax credits for such taxes to shelter other, lightly taxed foreign income from U.S. tax.

There is a separate foreign tax credit limitation under the Act for dividends from each noncontrolled foreign corporation that are eligible for deemed-paid foreign tax credits (with separate treatment for the portion of such dividends attributable to high withholding tax interest).

In general, certain payments from, and inclusions under subpart F with respect to, controlled foreign corporations are subject to the new separate limitations for passive, financial services, shipping income, high withholding tax interest, and dividends from noncontrolled section 902 corporations under look-through rules that take into account the extent to which the controlled foreign corporations themselves earn income of a type subject to the new separate limitations.

The Act also authorizes the IRS to prescribe regulations preventing manipulation of the character of income the effect of which is to avoid the purposes of the separate foreign tax credit limitations.

Under the Act, the deemed-paid credit for a U.S. corporation's share of foreign taxes paid by a foreign corporation is determined for post-1986 earnings on the basis of the post-1986 pool of the foreign corporation's accumulated earnings and profits rather than, as under prior law, on a year-by-year basis with the most recent year's earnings and profits taken into account first. Earnings and profits for this purpose generally are computed in the same manner for actual distributions as they are under present and prior law for tax-haven (subpart F) income inclusions. Modified foreign currency translation rules apply for both actual distributions and subpart F income inclusions. (These translation rules are discussed at F., below.) For pre-1987 earnings, the deemed-paid credit continues to be determined using the year-by-year method of prior law.

The Act provides that separate limitation and overall limitation losses are to be allocated to other foreign income before U.S. income, subject to a recharacterization rule applicable in years following the loss year when income is earned in the loss basket. In addition, if, in one year, a taxpayer incurs a U.S. loss and earns income in more than one foreign income basket, the U.S. loss is to be allocated pro rata among the foreign income baskets.

The Act also clarifies and codifies a Treasury regulation denying foreign tax credits for foreign taxes used directly or indirectly as subsidies to the taxpayer or certain persons connected with the taxpayer.

2. Separate foreign tax credit limitations

Separate limitation for passive income

General definition of passive income

The Act replaces the separate limitation for passive interest income with a separate limitation for passive income generally. The Act generally defines passive income as any income of a kind which would be subpart F foreign personal holding company income (as defined in Code sec. 954(c), as amended by the Act). Thus, passive income for separate limitation purposes generally includes dividends, interest, annuities, and certain rents and royalties. The Act modifies the subpart F definitions of foreign personal holding company income and of a related person (sec. 1221 of the Act). (These changes in the anti-tax haven rules are discussed in more detail at C., below.) In general, these definitional changes apply for purposes of the separate limitation for passive income as well. Some of the categories of passive income affected or created by the modifications to the definition of foreign personal holding company income are discussed separately, immediately below.

Subject to "look-through" exceptions described below, the types of income treated under the Act as passive income generally receive that separate treatment whether received by a U.S.-controlled foreign corporation or a U.S. person directly. Thus, in many cases, interest or dividend income, for example, that would have been subpart F foreign personal holding company income if received by a U.S.-controlled foreign corporation will be passive income if received directly by a U.S. person.

Sales of property

Consistent with the subpart F definition of foreign personal holding company income, as modified by the Act, passive income generally includes the excess of gains over losses from the sale or exchange of any nonincome producing property or property that gives rise to the following types of subpart F foreign personal holding company income: first, dividends and interest; second, rents and royalties other than active business, unrelated party rents and royalties; and, third, annuities. Thus, gain on the sale of stock, which was under prior law and contiues to be foreign personal holding company income for Subpart F purposes, is passive income.[11]

Excluded from this rule are gains from the sale or exchange of property by a regular dealer in such property and gains from the sale or exchange of any other inventory property.

Commodities transactions

Also generally included in subpart F foreign personal holding company income and passive income under the Act is the excess of gains over losses from transactions (including futures, forward, and similar transactions) in commodities. However, gains and losses from commodity transactions are not taken into account in computing subpart F or passive income, when they (1) arise out of bona fide hedging transactions reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which that business is customarily and usually conducted by others, or (2) are active business gains or losses from the sale of commodities, but only if substantially all of the entity's business is that of an active producer, processor, merchant, or handler of commodities.

Foreign currency gains

The excess of foreign currency gains over foreign currency losses attributable to section 988 transactions (excluding transactions directly related to the business needs of the entity) is subpart F foreign personal holding company income and passive income under the Act. For this purpose, foreign currency gains and losses attributable to section 988 transactions are defined as they are for purposes of the Act's new rules relating to the taxation of foreign currency exchange rate gains and losses (sec. 1261 of the Act).

Income equivalent to interest

Consistent with the subpart F definition of foreign personal holding company income, as modified by the Act, passive income also includes income equivalent to interest. For this purpose, income equivalent to interest includes, for example, commitment fees for the actual lending of money.

Dividends, interest, rents, and royalties from related persons

As explained in more detail at C., below, the Act modifies the prior law exclusions from subpart F foreign personal holding company income of certain dividends, interest, rents, and royalties received from related persons (new Code sec. 954(c)(3)). The Act makes related party interest, rents, and royalty payments ineligible for the exclusions to the extent that they reduce subpart F income of the payor, eliminates the exclusion for interest paid between related banking, financing, and similar businesses, and, for five years, extends the same-country dividend exclusion to dividends attributable to specified mining-related income from a specified less than 50-percent owned corporation. In general, these modifications apply for passive basket purposes as well.

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[11] This rule for stock gains applies to nonsection 1248 gain amounts only. For purposes of determining the separate limitation character of any section 1248 gain, that gain is treated as a dividend. (See "*Other rules relating to new separate limitations,*" below.)

Foreign personal holding company and PFIC inclusions

Foreign personal holding company inclusions (under Code sec. 551) and passive foreign investment company inclusions (under new Code sec. 1293) other than those inclusions that are subject to the high-tax kick-out, described below, are passive income.

Export financing exception

The Act provides an export financing exception to the separate limitation for passive income. The Act generally excludes from the new separate limitation (and treats as overall limitation income) interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property which is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For this purpose, the fair market value of any property imported into the United States is its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. A related person, for this purpose is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the interest recipient, or a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the interest recipient. Control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing 50 percent or more of the total voting power of all classes of stock entitled to vote or of the total value of stock of the corporation. In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, of 50 percent or more (by value) of the beneficial interests in the partnership, trust, or estate. Rules for determining stock ownership similar to those applicable for subpart F purposes (Code sec. 958) apply.

Export financing exceptions are also provided by the Act with respect to the separate limitations for financial services income and high withholding tax interest and the termination of tax deferral for banking income of controlled foreign corporations (discussed at C.1.a., below).

The export financing exceptions do not liberalize prior law's separate limitation rules. Thus, the export financing exceptions to the separate limitations for passive and financial services income and high withholding tax interest do not apply to interest that would have been separate limitation interest prior to the 1986 Act under the factoring rules of the Tax Reform Act of 1984 (*see* Code sec. 864(d)). Under the 1984 Act's factoring rules, any income of a controlled foreign corporation from a loan to a person for the purpose of financing the purchase of inventory property of a related person is interest for separate limitation purposes without regard to the exceptions to prior law's separate limitation for interest; thus, under the 1986 Act, such income of a controlled foreign corporation is not eligible for the export financing exception to the new separate limitations either. For example, assume that a U.S. corporation wholly owns a foreign corporation. The U.S. corporation manufactures inventory property and sells some of the property to the foreign corporation. The foreign corporation in turn sells the property to unrelated foreign customers. The foreign corporation provides financing to those customers. Pursuant to that financing, the foreign subsidiary has interest income. Assuming for purposes of this example that that interest might otherwise qualify for the export financing exception to the separate limitations, the exception does not apply since (under Code sec. 864(d)(6)) the interest is received from loans to persons for the purpose of financing the purchase of inventory property of a related person (the U.S. parent).

The availability of the export financing exception for interest received directly by *U.S. persons* (rather than by controlled foreign corporations) is not restricted by the 1984 factoring rule governing loans made to finance inventory property purchases (sec. 864(d)(6)). Thus, for example, interest received by a U.S. finance company on loans made to foreign purchasers of inventory manufactured in the United States by and purchased from the finance company's manufacturing affiliate generally will qualify for the export financing exception.

As discussed below, the foreign tax credit limitation character of interest received from a controlled foreign corporation by a U.S. shareholder of the corporation is determined under look-through rules that take into account the foreign tax credit limitation character of the controlled foreign corporation's income. Whether interest received from a controlled foreign corporation by a U.S. shareholder of the corporation is overall limitation income rather than a separate limitation type of income depends upon the application of the look-through rules to that interest, not upon the direct application of the export financing exception to that interest.

Financial services income exception

Income that would otherwise meet the definitions of both financial services income (as defined below) and passive income is financial services income under the Act if received in a taxable year in which the recipient is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.

By contrast, amounts earned by an entity not predominantly engaged in the active conduct of a banking, insurance, financing, or similar business that apparently meet the definitions of both financial services income and passive income are passive income under the Act. The latter rule is intended to prevent entities earning passive income from characterizing it as financial services income in order to avoid the high-tax kick-out and other anti-abuse rules applicable to that income, which are discussed below.

Shipping income exception

The Act excludes shipping income subject to its own separate limitation from the definition of passive income. Income, such as rental payments for the use of a vessel, that otherwise is both of a kind which would be subpart F foreign personal holding company income and of a kind which would be foreign base company shipping income is subject to the separate limitation for shipping income rather than to the separate limitation for passive income.

This priority rule parallels the present- and prior-law subpart F priority rule for income that is otherwise both subpart F foreign personal holding company income and foreign base company shipping income. It conforms the separate limitation and subpart F rules and thereby simplifies the application of the separate limitation rules.

Oil and gas income exception

The separate limitation for passive income does not apply to foreign oil and gas extraction income (as defined in Code sec. 907(c)).

Active rents and royalties exception

Consistent with the subpart F foreign personal holding company rules of present and prior law, the Act excludes from passive income any rents or royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person. Rents and royalties received from certain related persons also may be excluded from passive income under the look-through rules discussed in detail below.

In general, under Treas. Reg. sec. 1.954-2(d)(1), whether rents and royalties received from unrelated persons are derived in the active conduct of a trade or business is determined under a facts and circumstances test. In addition, these regulations provide safe harbor rules. In general, Congress anticipated that the standards contained in these existing regulations defining rents and royalties for purposes of excluding such rents and royalties from subpart F taxation would be followed in determining whether rents and royalties received from unrelated persons qualify for the exclusion from the separate limitation for passive income. However, Congress noted that the standards contained in the existing regulations would have to be modified somewhat for this purpose.

For example, Congress expressed the expectation that the Secretary would appropriately take into account the fact that the persons receiving the rents and royalties will sometimes be U.S. persons rather than controlled foreign corporations. In addition, Congress indicated that it expected that the Secretary, in adapting the standards contained in the existing regulations, would require any determination based on facts and circumstances and any additional safe harbor rules to be consistent with the principles underlying the safe harbor rules of the existing regulations. Congress further expected that the Secretary, in adapting the standards contained in the existing regulations would, to the extent possible, substitute for the facts and circumstances test included therein more objective rules for distinguishing between active and passive rents and royalties. Congress believed that it might be appropriate in some cases to apply such rules on a consolidated group basis in the case of U.S. recipients of rents and royalties that join in filing a consolidated return.

High withholding tax interest exception

The Act excludes high withholding tax interest from the definition of passive income.

De minimis exception

The Act provides that a controlled foreign corporation has no passive income (or financial services income, shipping income, high withholding tax interest, or separate limitation dividends from a noncontrolled section 902 corporation) in a taxable year in which the corporation has no subpart F income by reason of the applicability of the subpart F de minimis rule (Code sec. 954(b)(3)(A)), as that rule is modified by the Act. Under the Act, the subpart F de minimis rule generally applies if the sum of gross foreign base company income and tax haven insurance income is less than the lesser of 5 percent of gross income or $1 million.

The Act adopts this separate limitation de minimis rule in the interest of administrative convenience. The amount of passive income of a controlled foreign corporation is relevant for separate limitation purposes because (as discussed in greater detail below), under look-through rules, that amount determines the extent to which subpart F inclusions with respect to the corporation, and payments by the corporation to certain related persons, are included in the passive income basket. To simplify the application of the look-through rules, the Act includes this rule, and others, that conform the operation of subpart F and the separate limitations. As a result of the separate limitation de minimis exception, a controlled foreign corporation that has no currently taxable foreign personal holding company income for a year because of the subpart F de minimis rule has no passive income for that year for separate limitation look-through purposes. Dividends paid from that year's earnings, and interest, rents, and royalties paid to U.S. shareholders during the year, have no passive income component.

Assume, for example, that a foreign corporation wholly owned by a U.S. company has $100 of gross income. Ninety-six dollars of that income consists of manufacturing income and nonsubpart F sales income, $1 is foreign base company sales income, and $3 is foreign personal holding company income. The foreign corporation pays $10 of interest, $5 of royalties, and no dividends to its U.S. parent. The subpart F de minimis rule applies so the U.S. parent has no subpart F inclusion with respect to the foreign corporation. Consequently, under the separate limitation de minimis rule, the $3 of foreign personal holding company income is treated as overall limitation income rather than passive income. Thus, the $10 of interest and $5 of royalty payments are overall limitation income to the parent in their entirety. In addition, for purposes of determining the foreign tax credit limitation treatment of future dividends, earnings and profits of the foreign corporation for this year will have no separate limitation component.

The separate limitation de minimis rule does not apply to income received by U.S. persons that is not received through a controlled foreign corporation.

Regulated investment company exception

Under the Act, dividends received by a controlled foreign corporation from a regulated investment company may be excluded from passive income under the de minimis rule for controlled foreign corporations described immediately above.

Manipulation of the character of income and exception for passive income that attracts high foreign tax

Passive income earned abroad sometimes bears relatively high, rather than low, foreign tax. For example, portfolio dividends (which generally are included in foreign personal holding company income) are sometimes subject to high gross withholding taxes. Also, taxpayers may take the position that they can allocate expenses in a manner that effectively shifts, for foreign tax credit limitation purposes, high taxes paid on overall limitation income to passive income generated specifically for the purpose of such reallocation of foreign taxes. Assume, for example, that a U.S. company operates a foreign subsidiary in a high tax country. The subsidiary has $10,000 of assets and earns $1,000 of manufacturing income. Five hundred dollars of foreign tax is imposed on that income. The subsidiary repatriates all the income currently, free of any additional foreign withholding tax. The repatriated income is subject to the overall limitation. The U.S. company also receives $300 of passive income from investments in a tax haven country. The $300 bears no foreign tax and is subject to the separate limitation for passive income.

Under the Act, the company's U.S. tax liability on its foreign income is $102 (34 percent of $300): the tax is attributable entirely to the company's separate limitation passive income; the deemed-paid foreign tax credit for the $500 of tax imposed on the company's $1,000 of repatriated manufacturing income eliminates any U.S. tax liability with respect to that income. Because the $500 deemed-paid credit exceeds the $340 of U.S. tax on the manufacturing income, the company has excess foreign tax credits in the overall limitation basket.

The company might take the position, however, that it can use some of its excess credits to reduce its U.S. tax liability on its passive income by entering into the following pair of transactions: the company's high tax country subsidiary borrows $8,000 at 10-percent interest and purchases an $8,000 certificate of deposit paying 10-percent interest. These transactions "wash": the company continues to earn $1,000 of manufacturing income in its high tax country subsidiary and $300 of passive investment income in the tax haven. The foreign tax on the company's $1,000 of high tax country income remains $500. However, absent the anti-abuse rules in the Act described below, the company might argue, based on calculations described below, that allocation of its subsidiary's $800 of interest expense results in the company's having $556 of high tax country active income, bearing $278 of foreign tax, and $444 of high tax country passive income, bearing $222 of foreign tax. This result could obtain were the asset method used to allocate the subsidiary's interest expense between its $1,000 of manufacturing income and $800 of passive interest. Under the asset method, $444 of its interest expense ($10,000/$18,000 x $800) would be allocated to its $1,000 of manufacturing income resulting in net manufacturing income of $556, while $356 ($8,000/$18,000 x $800) would be allocated to the subsidiary's $800 of interest income resulting in net passive income at the subidiary level of $444. If $444 of the subsidiary's $1,000 of earnings were in fact treated as high tax country passive income bearing $222 of the foreign tax, then the company's U.S. tax liability would be reduced to $30.96: pre-credit tax of $252.96 on the company's $744 ($300 + $444) of passive income, less a $222 deemed-paid credit for the foreign tax allocated to the passive interest. (The $556 still characterized as active income would continue to be free of U.S. tax because of the deemed-paid credit assigned to it.)

The Act requires the IRS to prescribe such regulations as may be necessary or appropriate to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations. Congress intended that the regulations prevent manipulation of the character of income such as that illustrated in the above example and, in addition, other manipulations of income character that have little economic significance in relation to the reduction of post-foreign tax credit U.S. tax liability. For example, Congress indicated that it expected that in the above example the regulations would provide that the borrowing and lending pair of transactions be ignored for foreign tax credit limitation purposes.

To ensure that the separate limitation for passive income segregates low-taxed income from high-taxed income as intended and that substantial averaging within the passive basket is avoided, the Act also contains a mechanical rule excluding high-taxed income from the passive basket (the "high-tax kick-out"). For this purpose, high-taxed income is any income which would otherwise be passive income if the effective rate of foreign tax on the income exceeds the highest rate of U.S. corporate or individual tax (whichever applies). The effective rate of foreign tax is computed by dividing the sum of the foreign income taxes paid or accrued by the taxpayer with respect to the income and the foreign income taxes treated as paid by the taxpayer with respect to the income by the amount of the income (grossed-up for any deemed-paid foreign taxes pursuant to Code section 78). Income, for this purpose, is measured under the United States' tax rules, not foreign countries' tax rules, and is reduced by allocable expenses. Foreign income taxes, for this purpose, are any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States. The highest rate of individual tax in taxable years beginning in 1987, a transitional year, is 38.5 percent (*see* new Code sec. 1(h)). The highest rate of corporate tax in taxable years that include July 1, 1987 (other than as the first day of such year) is the highest blended rate specified in Code section 15. The high-tax kick-out is applied on an annual basis.

The high-tax kick-out is similar in certain respects to Code section 954(b)(4), as modified by the Act, which generally excludes from foreign base company income and insurance income that income subject to an effective rate of foreign income tax greater than 90 percent of the maximum U.S. corporate tax rate. However, the separate limitation high-tax kick-out provision, unlike the Code section 954(b)(4) provision, is self-executing. (Section 954(b)(4) applies only if a taxpayer establishes to the Secretary's satisfaction that its requirements are satisfied.)

The high-tax kick-out applies after allocation of expenses at the U.S. recipient level. For example, assume that a foreign corporation that earns only passive income for the year makes a $100 rent payment to its 100-percent U.S. owner. The payment attracts a $30 foreign withholding tax. Under the look-through rule for rents, the $100 would be passive income to the U.S. owner, absent the high-tax kick-out. Before the high-tax kick-out is applied, parent expense must be allocated to the $100 of income. Assume that $40 of parent expense is properly allocated to the $100. Pursuant to the high-tax kick-out, the $60 of net rental income is recharacterized as overall limitation income (and the $30 withholding tax is placed in the overall basket) because the foreign income tax paid with respect to that income exceeds the highest U.S. tax rate multiplied by the amount of the income after allocation of parent expense (that is, $30 > (.34 x $60)).

The Act does not mandate separate application of the high-tax kick-out to individual items of income which the Secretary determines can be grouped for purposes of applying the kick-out without diminishing substantially its effect. Congress indicated that it expected the Secretary, in making such determinations, to balance the administrative convenience that might be gained from grouping particular items of income against the increased sheltering opportunities that might be created by such grouping. Congress believed that it is generally appropriate to apply the high-tax kick-out to the passive portion of a subpart F inclusion *in toto*, rather than separately to each item of income included in the passive income inclusion. However, such treatment is not appropriate where it would allow taxpayers to shelter from U.S. tax income subject to little or no foreign tax that is generated by passive investments made through controlled foreign corporations which receive other passive income bearing relatively high foreign tax.

Dividends paid by a controlled foreign corporation generally will not be passive under the Act (*see* discussion of look-through rules below). Such dividends are, therefore, generally to be excluded from any income grouping to which the high-tax kick-out is applied.

Congress indicated that it expected the Secretary to examine the extent to which it would be feasible, consistent with the purposes of the kick-out, to apply it to a foreign branch's total passive income carrying direct foreign tax credits, rather than separately to each item of passive income of the branch that carries a direct foreign tax credit. A foreign branch might be defined for this purpose by reference to the definition of a "qualified business unit" provided in the Act's rules for the tax treatment of foreign currency exchange gain and loss (*see* F., below).

The high-tax kick-out applies at the U.S. person level only. For example, assume that two foreign corporations are wholly owned by a common U.S. parent. The foreign corporations are incorporated in different countries. The first foreign corporation has $100 of income (after expenses other than foreign tax). All of the corporation's gross income is passive. The $100 attracts $45 of foreign tax. (The taxpayer does not exclude this income from subpart F taxation under subpart F's high foreign tax rule (Code sec. 954(b)(4)).) This income is currently taxed to the U.S. parent under subpart F. For purposes of applying the high-tax kick-out, $5 of parent expense is allocated to this income. The income is overall limitation income to the U.S. parent because the foreign tax treated as paid by the parent on the income (under Code sec. 960) exceeds the highest U.S. tax rate multiplied by the amount of the income after the Code section 78 gross-up for deemed-paid foreign tax and the allocation of parent expense (that is, $45 > (.34 x $95)).

Among the first foreign corporation's expenses is a $20 royalty payment to the second foreign corporation. The only foreign tax attracted by this royalty payment is a $1 withholding tax. Under the look-through rules, the $20 is generally passive income to the second foreign corporation. The high-tax kick-out does not apply at the controlled foreign corporation level; thus, the $45 of foreign tax imposed on the first foreign corporation's income has no bearing on the characterization of its royalty payment to the second foreign corporation. This rule simplifies the application of the high-tax kick-out. Congress also believed that it was appropriate for two additional reasons. First, the $20 royalty payment in the example bore none of the $45 of tax paid by the first foreign corporation: rather, it reduced the first foreign corporation's taxable income; the $45 of tax was imposed on the first foreign corporation's $100 of income after deductions, including that for the royalty payment. Second, foreign taxes are relevant for foreign tax credit limitation purposes only at that point at which direct or deemed-paid foreign tax credits are provided for them. Such credits are generally provided only when a *U.S.* person includes the associated income in its gross income for U.S. tax purposes.

Returning to the example, the $20 of passive royalty income is subpart F foreign personal holding company income to the second foreign corporation, currently taxable to its U.S. parent. One dollar of parent expense is allocated to the subpart F inclusion for purposes of applying the kick-out. The subpart F inclusion remains passive after application of the kick-out because the $1 of foreign withholding tax treated as paid by the U.S. parent on this income (under Code sec. 960) does not exceed the highest U.S. tax rate multiplied by the amount of the income after the Code section 78 gross-up for deemed-paid foreign tax and the allocation of parent expense (that is, $1 < (.34 x $20)).

The Secretary is to prescribe rules for the proper application of the high-tax kick-out in cases involving distributions of income previously taxed under subpart F that themselves attract foreign tax. With respect to such distributions, any adjustment in tax liability normally is to be required in the year of the distribution rather than in the year of the subpart F inclusion, and is to be consistent with present and prior law's special rules for determining foreign tax credits with respect to distributions of earnings and profits previously taxed under subpart F (*see* Code sec. 960(b)). With respect to all the separate limitations, Congress intended that foreign taxes imposed on distributions of income previously taxed under subpart F, to the extent creditable under the special rules just noted, be assigned to the same limitation basket or baskets as the prior subpart F inclusions to which they relate. The Secretary also is to prescribe rules for the proper application of the high-tax kick-out to income taken into account on an accrual basis under a foreign country's tax rules but on a cash basis under U.S. tax rules (and vice-versa).

The high-tax kick-out does not apply to income in either the financial services income basket or the shipping income basket. This reflects the judgment of Congress that a bona fide financial services company, or shipping company, while it should not be able to average its financial services or shipping income with any other, unrelated types of income, generally should be able to obtain the benefits of foreign tax rate averaging with respect to its active business income to the same extent that, for example, a manufacturing or service enterprise can. The high-tax kick-out does apply, however, to amounts includible in gross income under the foreign personal holding company rules or the passive foreign investment company rules.

Separate limitation for financial services income

General definition of financial services income

The Act establishes a separate limitation for financial services income. The separate limitation applies to income received or accrued by any person which is not passive income and which is derived in the active conduct of a banking, financing, or similar business or from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business. Separate limitation financial services income also includes, with one modification discussed below, any income which is not passive income and which is of a kind which would be insurance income under subpart F (Code sec. 953(a), as modified by the Act).

The limitation for financial services income is so named to emphasize the broad range of income types to which the separate limitation applies. For purposes of the new separate limitation, income derived in the active conduct of a banking, financing, or similar business generally includes income attributable to any of the activities listed in existing Treas. Reg. sec. 1.954-2(d)(2)(ii)(A) through (G). In addition, it generally includes service fee income from investment and correspondent banking, income earned by broker-dealers in the ordinary course of business (such as commissions), earnings from interest rate and currency swap businesses, income from services provided to unrelated parties with respect to the management of funds, income from fiduciary services provided to unrelated parties, bank-to-bank participation income, charge and credit card services income from financing purchases from third parties, gains on the disposition of tangible personal property that was used in the active conduct of a financial services business and that generated only financial services income prior to its disposition, hedging gains with respect to other financial services income, and income from travellers' check services.

Under the Act, income that meets the definition of subpart F insurance income, whether received by a controlled foreign corporation or by another entity, generally is considered financial services income. Thus, financial services income generally includes any income attributable to the issuing (or reinsuring) of any insurance or annuity contract. Insurance income generally is not subject to current taxation under subpart F if the risk insured is in the country in which the insurer is created or organized. For purposes of the separate limitation for financial services income, however, this same-country risk exception does not apply. Under the Act, subpart F insurance income and, therefore, separate limitation financial services income also include any income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of premium for insurance of other-country risks. In addition, the separate limitation applies to income of offshore captive insurance companies which the Act subjects to subpart F taxation under special subpart F ownership rules. Insurance income subject to the separate limitation consists of premium and other insurance income (such as investment income).

The amount of insurance income subject to tax under subpart F and, therefore, subject to the separate limitation is the amount that would be taxed under subchapter L (as modified by the Act) of the Code if it were the income of a domestic insurance company (subject to the modifications provided in Code section 953(b)).

As discussed in greater detail at C., below, the Act generally imposes current tax on all foreign personal holding company income earned by banks and insurance companies (subject to an exclusion for high-taxed income) by repealing rules that previously excluded from foreign personal holding company income for subpart F purposes certain dividends, interest, and gains received by persons in the banking, financing, and insurance businesses. Financial services income subject to current taxation under subpart F, as modified by the Act, is a narrower category of income than financial services income subject to the new separate limitation, since the separate limitation is not limited in its application, as the subpart F inclusion rules with respect to financial services income generally are, to foreign personal holding company income.

Predominantly engaged test

The Act provides a special rule for entities predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. If an entity is so engaged for any taxable year, then the separate limitation for financial services income includes any passive income earned by the entity in that year as well as its other financial services income. This predominantly engaged rule, among other things, acknowledges the practical difficulty of distinguishing passive income of a bank, insurance company, finance company, or similar business—most or all of the income of which arises from financial activity—from its active income. Income of a predominantly engaged entity that would otherwise meet the definitions of both shipping income and financial services income is considered the latter for separate limitation purposes under the Act.

Congress expressed the expectation that the Secretary would prescribe rules for determining whether an entity is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. Generally, unless a high percentage of an entity's income is attributable to financial services activities of the types enumerated above, such entity is not to be considered predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. Bank holding companies, within the meaning of the Bank Holding Company Act of 1956, as amended, are to be considered predominantly engaged in the active conduct of a banking business.

Moreover, if an entity satisfies the predominantly engaged test, then income it earns that is integrally related to its banking, insuring, or financing activity generally is to be treated as financial services income, notwithstanding that such income might not be financial services income in the hands of another person. Congress anticipated that income from precious metals trading, commodity trading, finance leasing income that would not qualify as "active" leasing income under subpart F (sec. 954(c)(2)(A)), and the financing of trade that is integrally related to the banking, insuring, or financing activity of an entity satisfying the predominantly engaged test might be treated as financial services income of that entity. For example, income from trading precious metals that could be overall limitation income in the hands of a mining company could be financial services income in the hands of a predominantly engaged entity. Similarly, income that would be passive income in some cases (such as finance leasing income) would be financial services income in the hands of a predominantly engaged entity.

An entity that is predominantly engaged in activities (such as finance leasing) that would yield passive income if viewed in isolation may be treated as predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.

In no event is income attributable to nonfinancial activity to be treated as financial services income. Thus, for example, income from data processing services or nonfinancial services (at least if not rendered for an affiliate satisfying the predominantly engaged test) or the sale of goods is not financial services income, even if the recipient satisfies the predominantly engaged test.

Export financing exception

The Act provides an export financing exception to the separate limitation for financial services income. This exception is identical to the export financing exception to the separate limitation for passive income, which is described above in the discussion of the separate limitation for passive income.

Priority rules

High withholding tax interest subject to its own separate limitation (see below) is not subject to the separate limitation for financial services income. This exclusion applies whether or not the recipient satisfies the predominantly engaged test.

Income that might otherwise meet the definitions of both passive and financial services income is passive income for separate limitation purposes when the recipient fails to satisfy the predominantly engaged test. This rule prevents entities making essentially passive investments such as occasional loans from avoiding the high-tax kick-out and other anti-abuse rules applicable to the separate limitation for passive income by taking the position that the associated income is financial services income rather than passive income.

Separate limitation for shipping income

The Act establishes a separate foreign tax credit limitation for shipping income. The separate limitation for shipping income applies to income received or accrued by any person which is of a kind which would be foreign base company shipping income (as defined in Code sec. 954(f), as amended by the Act). Thus, the separate limitation applies to income received directly by U.S. persons as well as to income received by controlled foreign corporations. As discussed in more detail at C., below, the Act repeals the exclusion from foreign base company shipping income for reinvested shipping income and adds to base company shipping income certain income derived from space or ocean activities.

Separate limitation for high withholding tax interest

Under the Act, a separate foreign tax credit limitation applies to high withholding tax interest. High withholding tax interest generally is any interest subject to a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more.

The separate limitation for high withholding tax interest generally does not apply to export financing interest. This exception is identical to the export financing exceptions to the separate limitations for passive and financial services income. The exception is fully described above in the discussion of the separate limitation for passive income. Interest excluded from the separate limitation for high withholding tax interest under the export financing exception is treated as overall limitation income unless the interest is received by an entity predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In the latter case, such interest is treated as financial services income.[12]

As discussed below, under the look-through rules, the separate limitation for high withholding tax interest applies if a controlled foreign corporation makes a high withholding tax loan; the separate limitation's applicability is not limited to high withholding tax loans by U.S. persons. Without such look-through treatment, U.S. persons might avoid the separate limitation by originating high withholding tax loans in, or moving such loans to, controlled foreign corporations.

A similar potential for avoidance exists with respect to noncontrolled section 902 corporations: high withholding taxes imposed on interest income earned by a noncontrolled section 902 corporation are eligible for the deemed-paid credit. In lieu of look-through treatment for dividends from noncontrolled section 902 corporations, Congress adopted a special mechanism for limiting deemed-paid credits in the case of high withholding tax loans.

Under the Act, taxes on high withholding tax interest, to the extent imposed at a rate exceeding 5 percent, are not treated as foreign taxes for purposes of determining the amount of foreign taxes deemed paid by a taxpayer with respect to dividends received from a noncontrolled section 902 corporation.

An example illustrates the operation of this special rule. Assume that an offshore bank has a 40-percent U.S. owner and a 60-percent foreign owner. It earns $2,000 of gross interest income and incurs $1,700 of interest expense. One thousand dollars of the interest income is subject to a 10-percent gross withholding tax and is, therefore, high withholding tax interest.

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[12] A technical correction may be needed so that the statute reflects this intent.

The foreign corporation incurs no other expenses and earns no other income. Its earnings and profits are $200 ($2,000 gross interest income less $1,700 interest expense less $100 withholding tax). It pays the full $200 out as dividends. Its U.S. shareholder receives $80 (40 percent) of the $200. The provision treats as noncreditable that portion of the 10-percent withholding tax exceeding 5 percent. Therefore, $50 (5 percent of $1,000) of the $100 withholding tax is noncreditable. The U.S. shareholder's deemed-paid credit with respect to the $80 dividend it receives is therefore reduced from $40 (40 percent of $100) to $20 (40 percent of $50).

The separate limitation for high withholding tax interest and the special rule just described may apply to any foreign gross-basis tax imposed on interest income. In addition, Congress intended that, under regulations, other taxes on interest that are substantially similar in the sense that their imposition results in heavier taxation by the levying country of foreign lenders than residents also be subjected to the new rules. The Act states that the Secretary may by regulations provide that amounts (not otherwise high withholding tax interest) will be treated as high withholding tax interest where necessary to prevent avoidance of the purposes of the separate limitations.

Separate limitation for dividends from noncontrolled section 902 corporations

In general, when a foreign corporation that is not a controlled foreign corporation pays dividends that are eligible for the section 902 deemed-paid foreign tax credit (which is generally available for dividends from foreign corporations in which the recipient owns at least 10 percent of the voting power), a separate foreign tax credit limitation applies to the dividends received. Under this separate limitation for dividends from "noncontrolled section 902 corporations," foreign taxes associated with dividend income may offset U.S. tax only on dividend income from that corporation. The taxes affected by this separate limitation are foreign withholding taxes imposed on these dividends and foreign taxes deemed paid with respect to these dividends. This separate limitation also applies to dividends eligible for the deemed-paid credit that are paid by a controlled foreign corporation out of earnings and profits generated while the payor was not a controlled foreign corporation. Income subject to this separate limitation is not subject to the separate limitations for passive, financial services, or shipping income. That is, the separate limitation for dividends from noncontrolled section 902 corporations takes priority over the other separate limitations. If, for example, a 30-percent U.S.-owned foreign banking company pays a dividend to its sole U.S. owner, also a banking company, then the dividend is subject to the separate limitation for dividends from noncontrolled section 902 corporations, not to the separate limitation for financial services income.

An example illustrates the operation of the separate limitation for dividends from noncontrolled section 902 corporations. A U.S.

corporation owns 40 percent of a foreign corporation that is not a passive foreign investment company (described in new Code sec. 1296). No other U.S. person owns any direct or indirect interest in the foreign corporation. The foreign corporation pays a dividend of $80 to the U.S. corporation. A $16 withholding tax is imposed on that dividend, so the U.S. corporation receives a net payment of $64. A $40 deemed-paid credit is associated with the dividend. The U.S. corporation includes $120 in income ($80 grossed up by the $40 deemed-paid foreign tax). That $120 carries with it foreign tax credits of $56. Those foreign tax credits exceed the $40.80 of pre-credit U.S. tax on the $120. The Act's limitation provides that the $15.20 of excess credits cannot offset U.S. tax on income other than prior or later dividends from this foreign corporation.

If a controlled foreign corporation owns 10 percent or more of the stock in foreign corporations that are not themselves controlled foreign corporations, then dividends from those non-controlled foreign corporations to the controlled foreign corporation that are eligible for the deemed-paid credit are subject to separate limitations for dividends from noncontrolled section 902 foreign corporations. Under the look-through rules discussed below, subpart F inclusions with respect to the controlled foreign corporation, and dividends, interest, rents, and royalties received from it by its U.S. shareholders are subject to separate limitations to the extent attributable to the foreign corporation's dividend income subject to the separate limitations.

As discussed above, the Act generally establishes a separate limitation for high withholding tax interest. A special rule relating to that separate limitation restricts deemed-paid credits for high withholding taxes on interest received by noncontrolled section 902 corporations.

The separate limitation for dividends from noncontrolled section 902 corporations does not limit the application of the special foreign tax credit rules for foreign oil and gas income (Code sec. 907). For example, prior law's look-through rules for inclusions with respect to foreign corporations with foreign oil and gas income (sec. 907(c)(3)) remain fully in effect, and operate in addition to the separate limitation for dividends paid by noncontrolled section 902 corporations.

These look-through rules are preserved with respect to dividends from noncontrolled section 902 corporations, and deemed-paid credits carried by such dividends are limited for taxes on high withholding tax interest because the separate limitation for dividends from noncontrolled section 902 corporations is not alone sufficient to prevent the cross-crediting of high foreign taxes on interest and oil and gas income against the U.S. tax on low-taxed income. Without the above restrictions, cross-crediting could still be achieved with respect to dividends from noncontrolled section 902 corporations that earn low-taxed income as well as high-taxed interest or oil and gas income.

Look-through rules

Dividends, interest, rents, and royalties received from controlled foreign corporations by their U.S. shareholders generally are subject to the separate limitation for passive income, the separate limitation for financial services income, the separate limitation for shipping income, the separate limitations for high withholding tax interest, the separate limitation for dividends from noncontrolled section 902 corporations, or the overall limitation (as the case may be) in accordance with look-through rules that take into account the extent to which the income of the payor is itself subject to one or more of these limitations. A dividend received from a controlled foreign corporation by a U.S. shareholder of that corporation, for example, is not automatically treated as 100-percent passive income because it is income of a kind which would be subpart F foreign personal holding company income. Subpart F inclusions are subject to a look-through rule too.

The look-through rules for dividends, interest, rents, and royalties replace the related party interest exception (old Code sec. 904(d)(1)(C)) to the prior law separate limitation for interest. The Act also supplants the rules enacted in 1984 to maintain the separate limitation character of interest income (old Code sec. 904(d)(3)).

Subpart F inclusions generally

The Act generally treats inclusions under Code section 951(a)(1)(A) with respect to income of a controlled foreign corporation as income subject to the overall limitation, income subject to the separate limitation for passive income, income subject to the separate limitation for financial services income, income subject to the separate limitation for shipping income, income subject to the separate limitation for high withholding tax interest, or income subject to the separate limitations for dividends from noncontrolled section 902 corporations (as the case may be) to the extent attributable to income of the controlled foreign corporation subject to each of these limitations. Under Code section 951(d) (amended as part of the Tax Reform Act of 1984), an amount that would otherwise constitute both a subpart F inclusion and a foreign personal holding company inclusion (under Code sec. 551(a)) is treated as a subpart F inclusion. An amount that would otherwise constitute both a subpart F inclusion and a passive foreign investment company inclusion (under sec. 1293 of the Act) also is treated as a subpart F inclusion for these purposes (new Code sec. 951(f)).

The general look-through rule for subpart F inclusions may be illustrated as follows: Assume that a controlled foreign corporation wholly owned by a U.S. corporation earns $100 of net income. Ninety-five dollars of the income is foreign base company shipping income and $5 is interest from unrelated parties that is foreign personal holding company income for subpart F purposes. No foreign tax is imposed on the income. All of the income is subpart F income taxed currently to the U.S. parent corporation. Since $95 of the $100 subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for shipping income, $95 of the subpart F inclusion is treated as separate limitation shipping income of the parent corporation. Since $5 of the subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for passive income, $5 of the subpart F inclusion is treated as separate limitation passive income of the parent corporation.

Code section 956 inclusions triggered by an increase in earnings invested in U.S. property (sec. 951(a)(1)(B)) are subject to a different look-through rule: that applicable to dividends (see below). Section 956 inclusions are subject to the look-through rule for dividends rather than that for subpart F inclusions generally under the Act because section 956 inclusions, like dividends, are drawn pro rata from earnings and profits; they differ from foreign base company income inclusions in not being specifically identified with particular earnings of a controlled foreign corporation.

Interest, rents, and royalty payments in general

The Act treats interest, rents, and royalties received or accrued from a controlled foreign corporation in which the payee is a U.S. shareholder as income subject to the overall limitation, income subject to the separate limitation for passive income, income subject to the separate limitation for financial services income, income subject to the separate limitation for shipping income, income subject to the separate limitation for high withholding tax interest, or income subject to the separate limitations for dividends from noncontrolled section 902 corporations (as the case may be) to the extent properly allocable (under regulations prescribed by the Secretary) to income of the controlled foreign corporation subject to each of these limitations. Under this rule, for example, royalties paid to a parent corporation by a foreign subsidiary that itself earns only overall limitation income are treated as overall limitation income. Similarly, interest paid to a parent financial institution by a subsidiary that itself earns only high withholding tax interest is treated as high withholding tax interest. Congress intended that interest, rents, and royalties be allocated for purposes of this rule using the same method used to compute the amount of any subpart F inclusion made with respect to the payor (see, for example, Code sec. 954(b)(5)).

The look-through rule for interest, rents, and royalties may be generally illustrated as follows: Assume that a foreign bank wholly owned by a U.S. financial institution earns $85 of gross interest income from bona fide, active banking loans made to unrelated persons. Twenty-five dollars of the interest is high withholding tax interest. The remainder is income of a type subject to the financial services separate limitation. The foreign bank incurs total nontax expenses of $115, consisting of $70 of interest paid on unrelated party deposits, $30 of interest paid to its U.S. parent, and $15 of rent paid to an unrelated party. Thus, the foreign bank incurs a net tax loss of $30 for the year. The foreign bank owns $500 of assets, consisting of high withholding tax loans of $145 and other unrelated party loans of $355. To determine how much of the $30 of interest payments to the U.S. parent is treated as separate limitation high withholding tax interest of the U.S. parent and how much of the $30 is treated as separate limitation financial services income of the parent, the payments must be allocated to gross high withholding tax interest and gross financial services income of the foreign bank. The asset method is used to allocate interest under the provision. Thus, $8.70 of the interest paid ($30 x $145/$500)) is allocated against the foreign bank's $25 of gross high withholding tax interest and $21.30 ($30 x ($355/$500)) against the foreign bank's $60 of financial services income. Therefore, $8.70 of the $30 of interest paid by the foreign bank to its U.S. parent is treated as separate limitation high withholding tax interest of the U.S. parent and $21.30 of the $30 of interest is treated as separate limitation financial services income of the U.S. parent.

Another application of the look-through rule for interest is illustrated as follows: Assume that a U.S. corporation wholly owns a foreign corporation. The U.S. corporation manufactures industrial equipment in the United States and sells some of the equipment to the foreign corporation for use in the foreign corporation's business. None of the fair market value of the industrial equipment is attributable to products imported into the United States. The U.S. corporation provides financing to its foreign subsidiary in connection with the subsidiary's purchase of the industrial equipment. Pursuant to that financing, the subsidiary pays its parent $100 of interest in a particular year. It also pays its parent $150 of interest on an unrelated loan. In that same year, all of the subsidiary's gross income is overall limitation income.

The separate limitation character of the $250 interest received by the U.S. parent from its controlled foreign corporation, including the $100 of export-related interest, is determined under the look-through rule for interest. Under that look-through rule, the entire $250 of interest is overall limitation income in the U.S. parent's hand because all of the controlled foreign payor's gross income is overall limitation income.

As discussed above, the Act requires the IRS to prescribe such regulations as may be necessary or appropriate to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations. To prevent the avoidance of the separate limitation for high withholding tax interest, it will be necessary in some circumstances to modify the application of the look-through rule for interest. If a U.S. person lends funds directly to an unrelated foreign person whose country of residence imposes a withholding tax of at least 5 percent on the interest paid on the loan, then the interest is high withholding tax interest subject to the separate limitation for such interest. U.S. banks might take the position, however, relying upon the look-through rule for interest, that they can avoid the separate limitation for high withholding tax interest by lending funds to a resident of a high withholding tax country through a bank subsidiary that is a controlled foreign corporation incorporated in that country, rather than directly. Taxpayers might argue that, under the look-through rule for interest, interest received in turn by the U.S. bank from the foreign bank subsidiary will not be high withholding tax interest, even though that interest attracts the foreign country's high withholding tax. Such a result would undermine the separate limitation for high withholding interest and, therefore, is to be precluded under the anti-avoidance regulations. The regulations may treat the interest received by the U.S. bank from the foreign bank subsidiary in this example as high withholding tax interest.

Direct allocation of interest payments

Except to the extent provided in regulations, interest payments or accruals by a controlled foreign corporation to a U.S. shareholder with respect to the corporation (or to another controlled foreign corporation related to such a U.S. shareholder) are allocated first to gross subpart F foreign personal holding company income of the corporation that is passive, to the extent of such income. The Secretary may, by regulations, extend this direct allocation to payments and accruals to unrelated persons. In addition, Congress anticipated that the rule would be extended to U.S.-controlled noncorporate payors and U.S.-controlled 80/20 company payors to the extent that look-through treatment of their interest payments is provided under regulations (see below). The direct allocation provision applies for subpart F and foreign tax credit limitation purposes. The general subpart F related person definition (Code sec. 954(d)(3)), as amended by the Act (*see* C.1.a., below) applies to determine whether a controlled foreign corporation is related to a U.S. shareholder for purposes of the direct allocation provision.

The Act treats interest paid by a controlled foreign corporation to a U.S. shareholder as first attributable to passive income under the theory that it would generally be as easy for the ultimate passive income recipient to have received the passive income directly as to have channeled it through a related corporation. In addition, this treatment of passive income prevents avoidance of tax through the use of back to back loans.

The direct allocation provision reduces subpart F foreign personal holding company income (compared to prior law) to the extent that it allocates to gross foreign personal holding company income interest expense that, under prior law, would have been allocated to nonsubpart F income. Concern about this effect of the direct allocation rule led Congress to provide regulatory flexibility so that the Secretary can apply different rules when the direct allocation provision would allow a tax advantage for offshore passive investments over domestic passive investments, or other unintended tax advantages.

An example illustrates the application of the direct allocation rule. Assume that a U.S. corporation wholly owns a foreign corporation and that the U.S. corporation also has $1,000 of cash. That controlled foreign corporation earns $100 of overall limitation manufacturing income, on which it pays $60 of foreign tax. The U.S. parent is free to invest its cash in the United States or abroad. Assuming equally safe investments, the parent will tend to seek the highest after-tax return.

If the U.S. parent earns $100 of bank deposit interest in the United States, it will generally pay $34 of U.S. tax on that interest income under the Act. The goal of the Act in a case such as this is to make sure that the parent does not pay less than that amount of tax if it indirectly earns an equivalent amount of passive income offshore.

Assume that the parent instead lends its $1000 of cash to its controlled foreign corporation. The foreign corporation deposits that cash in a foreign bank, and earns $100 of interest on the investment. The foreign subsidiary in turn pays $100 of interest to its U.S. parent. As indicated above, the Act provides that any interest received or accrued from a controlled foreign corporation by a U.S. shareholder in that corporation is treated as income subject to a particular separate limitation to the extent that that interest is properly allocable (under regulations prescribed by the Secretary) to income of the controlled foreign corporation that itself is subject to that separate limitation. Under the direct allocation provision, the $100 interest payment is properly allocable in full to the controlled foreign corporation's $100 of gross bank deposit interest, which is gross subpart F foreign personal holding company income subject to the separate limitation for passive income. Thus, the $100 of interest received by the U.S. parent is subject to the separate limitation for passive income. As a result, the U.S. parent cannot cross-credit foreign taxes paid on overall limitation income against the U.S. tax liability on that income. The $100 interest payment in effect removes all the passive income at the foreign subsidiary level. Thus, there is no subpart F inclusion for this taxable year. Any future dividend from the foreign subsidiary from its $100 of pre-foreign tax manufacturing earnings will consist solely of overall limitation income.

The following example illustrates the interaction between the direct allocation provision and the export financing exception to the separate limitation for passive income: Assume that a U.S. corporation wholly owns a foreign corporation. The U.S. corporation manufactures inventory property in the United States and sells some of the property to unrelated foreign purchasers. None of the fair market value of the inventory property is attributable to products imported into the United States. The foreign corporation provides financing to the unrelated foreign purchasers in connection with their purchases of the inventory property of the foreign corporation's U.S. parent. However, the foreign corporation is not engaged in the conduct of a banking business. The foreign subsidiary also provides nonfinancial services on behalf of its parent to the foreign purchasers of its parent's inventory property. The foreign subsidiary pays its parent $250 of interest in a particular year. In that same year, the subsidiary has $1,700 of gross income. Fifteen hundred dollars of that income is from the nonfinancial services that that corporation provides on behalf of its parent. The remaining $200 is interest paid by the purchasers of the U.S. parent's inventory property in connection with the financing provided to them by the foreign corporation. All of the nonfinancial services provided by the foreign corporation on behalf of its parent are performed outside the foreign corporation's country of incorporation.

All of the foreign corporation's gross income is subpart F income. The $1,500 of nonfinancial services income is foreign base company services income and overall limitation income. The $200 of interest received from purchasers of the U.S. parent's property is foreign personal holding company income, which is not eligible for the export financing exception because (under Code sec. 864(d)(6)) it is received from loans to persons for the purpose of financing the purchase of inventory property of a related person. That $200 is, thus, passive income.

Under the direct allocation provision, the $250 of interest paid to the U.S. corporation by its foreign subsidiary is allocable first to the foreign subsidiary's foreign personal holding company income that is passive. Since $200 of the subsidiary's gross income is foreign personal holding company income that is passive, $200 of the $250 is allocable to such income and is, therefore, passive income in the parent's hands. Because the remainder of the foreign subsidiary's gross income is overall limitation income, the remainder of the $250 of interest paid by the foreign subsidiary ($50) is allocable to overall limitation income of the subsidiary and is, therefore, overall limitation income in its parent's hands.

The Act does not provide explicit regulatory authority to the Secretary to extend the direct allocation provision to rents and royalties paid or accrued by controlled foreign corporations. The Senate version of the legislation, by contrast, applied a "stacking" rule (which the direct allocation rule replaced) to all payments to which look-through rules applied, including rents and royalties. Congress did not believe that back-to-back (or other) rent or royalty arrangements utilizing controlled foreign corporations should permit taxpayers to reduce the U.S. tax on foreign rent or royalty income. Congress was informed that existing regulatory standards under Code section 861 should operate to prevent taxpayers from allocating rent or royalty expense of controlled foreign corporations in order to achieve such results. Congress did not expressly extend the direct allocation rule to rents and royalties on the understanding that, under the existing regulations, direct allocation effectively is required in the problem cases just described (and others). Congress intended that the Secretary make any clarifications in the regulations that might be necessary to ensure that direct allocation takes place in such problem cases.

The allocation of interest expense of a controlled foreign corporation for purposes of the interest look-through rule and the foreign tax credit limitation rule maintaining the source of U.S. source income (present and prior Code sec. 904(g)(3)) is to be consistent. Thus, the direct allocation rule, where applicable for purposes of the interest look-through, applies for purposes of the U.S. source maintenance rule too.

For example, assume that a foreign corporation wholly owned by a U.S. corporation has $1,000 of gross foreign source manufacturing income and $150 of gross subpart F foreign personal holding company income. One hundred twenty-five dollars of this $150 is U.S. source income not effectively connected with a U.S. business. The other $25 is foreign source. The foreign corporation pays $150 of interest to its U.S. parent. Under the direct allocation rule, the $150 of interest expense is allocated in full to the foreign corporation's $150 of subpart F foreign personal holding company income and is, therefore, passive in the parent's hands. Under the Act, that allocation controls for purposes of determining the U.S. source portion of the $150. Thus (under Code sec. 904(g)(3)(C)), $125 of the $150 of interest expense is properly allocable to U.S. source income of the controlled foreign corporation and, consequently, is U.S. source to its parent.

Congress believed that using the same interest allocation method, including the direct allocation rule where applicable, in applying the provision maintaining the source of U.S. source income and the separate limitation look-through provision for interest achieves a desirable conformity in the operation of these two provisions. Congress was informed that technical difficulties arose under prior law in coordinating the provision maintaining the source of U.S. source income with the provision maintaining the character of interest income (old Code sec. 904(d)(3), which the look-through rules of the Act supplant) because the allocation approaches of these two provisions differed.

Dividends

The Act treats a portion of any dividend received from a controlled foreign corporation in which the recipient is a U.S. shareholder as overall limitation income, separate limitation passive income, separate limitation financial services income, separate limitation shipping income, separate limitation high withholding tax interest, or separate limitation dividends from a noncontrolled section 902 corporation (as the case may be) on the basis of a separate limitation income ratio. Subpart F inclusions attributable to investments by such a foreign corporation of its earnings in U.S. property are subject to the same rule. For each of these foreign tax credit limitation categories, the separate limitation income ratio of a dividend equals the separate limitation earnings and profits out of which the dividend was paid divided by the total earnings and profits out of which the dividend was paid. Under section 1202 of the Act (discussed in detail below), dividends are considered to be paid first from the post-1986 multi-year pool of the distributing corporation's accumulated profits (in the case of actual distributions) rather than, as under prior law, from the most recently accumulated profits of the distributing corporation. Congress intended that taxpayers use the same expense allocation method for determining separate limitation earnings and profits under this look-through rule, and for determining the portion of interest, rent, and royalty payments allocable to separate limitation passive, financial services, shipping income, separate limitation high withholding tax interest, and dividends from noncontrolled section 902 corporations under the look-through rule for such payments previously discussed.

The look-through rule for dividends operates as follows: Assume, for example, that a foreign corporation wholly owned by a U.S. corporation has no income in the current year. It pays a $200 dividend in the current year out of a 3-year post-enactment pool of earnings and profits. Earnings and profits for the earlier taxable years included in the 3-year pool were $1,000 and were not subpart F income. They were attributable to manufacturing and sales income derived in the foreign corporation's country of incorporation (overall limitation income) and dividends received by the corporation from a noncontrolled corporation incorporated and operating in the same country, in which the first corporation has a 50-percent ownership interest. Three hundred dollars of the earnings were attributable to the dividends just described. In the case of the separate limitation for dividends from noncontrolled section 902 corporations, the separate limitation income ratio with respect to the $200 dividend equals thirty percent ($300/$1,000). Therefore, thirty percent of the dividend, $60, is treated as a separate limitation dividends from this noncontrolled section 902 corporation in the U.S. parent's hands. The remainder of the dividend, $140, is treated as overall limitation income in the U.S. parent's hands.

If a controlled foreign corporation has earnings and profits for the current year but an accumulated deficit, and it pays a dividend, then the basis for application of the look-through rule for dividends is the current year's earnings and profits.

The Act contains a clarifying amendment to the provision that treats distributions of income previously taxed under subpart F as other than dividends (Code sec. 959(d)). This amendment is relevant to the application of the look-through rule for dividends. (It is also relevant to the calculation of the dividends received deduction for dividends from foreign corporations (Code sec. 245, as amended by the Act; *see* C.3., below) and the application of the dividend look-through provision of the rules maintaining the source of U.S. source income (Code sec. 904(g)(4)).) As indicated above, under the look-through rule for dividends, a proportionate amount of a dividend is treated as separate limitation income based on the ratio of the separate limitation earnings and profits out of which the dividend was paid to the total earnings and profits out of which the dividend was paid. The amendment makes clear that the numerator or the denominator (as the case may be) of this ratio is reduced by earnings and profits attributable to income that has been previously taxed under subpart F and distributed.

As an example, assume that a foreign corporation wholly owned by a U.S. corporation and engaged in a manufacturing business earns $20 of subpart F foreign personal holding company income, $20 of same-country dividend income from a 50-percent U.S.-owned foreign corporation, and $60 of manufacturing income. It thus has $100 of earnings and profits for the year. (For simplicity, this example assumes that net income, earnings and profits, and gross income are equal.) The $20 of subpart F foreign personal holding company income is currently taxed to the U.S. parent. The controlled foreign corporation distributes $40 in the year of the subpart F inclusion. Under the look-through rule for subpart F inclusions, the $20 of subpart F foreign personal holding company income is treated as passive income. Twenty dollars of the $40 distribution is not treated as a dividend because it is attributable to the $20 already taxed under subpart F (Code sec. 959(d)). Under the look-through rule for dividends, $5 of the $20 portion of the distribution that is a taxable dividend ($20/$80 x $20) should be treated as a separate limitation dividend from a noncontrolled section 902 corporation and $15 of that $20 ($60/$80 x $20) should be treated as overall limitation income. The clarifying amendment excludes from the denominator of the ratios just noted the portion of the year's $100 of earnings and profits attributable to the subpart F foreign personal holding company income ($20) and thus ensures that the described result is achieved technically.

De minimis exception and 70-percent full inclusion rule

If a controlled foreign corporation has no foreign base company income or subpart F insurance income in a taxable year because the corporation satisfies the subpart F de minimis rule (Code sec. 954(b)(3)(A), as amended by the Act; *see* C.1.c., below) for that year, then the look-through rules treat interest, rents, or royalties paid by the corporation during that year and dividends, to the extent treated as paid from that year's earnings and profits, as overall limitation income. Thus, the subpart F de minimis rule also functions as a de minimis rule for controlled foreign corporations with respect to the separate limitations for passive, financial services, and shipping income, and the separate limitations for high withholding tax interest and dividends from noncontrolled section 902 corporations.

If a controlled foreign corporation has no separate limitation income in a year by reason of the de minimis rule, Congress intended that the foreign loss allocation rule adopted in the Act (*see* 4., below), like the look-through rules, have no application to the corporation's income for the year.

The Act provides that the 70-percent full inclusion rule for foreign base company and insurance income (Code sec. 954(b)(3)(b), as amended by the Act; *see* C.1.c., below) does not result in overall limitation income of a controlled foreign corporation being treated as separate limitation income. Thus, for example, U.S. shareholders in a controlled foreign corporation who are taxed currently on all of the corporation's income because the corporation's foreign personal holding company income exceeds 70 percent of its income are required to treat as separate limitation passive income only that portion of the income that is foreign personal holding company income without regard to the 70-percent full inclusion rule. Foreign personal holding company income received directly by U.S. persons (rather than through a controlled foreign corporation owned by them) is not subject to the 70-percent rule either.

Exception for controlled foreign corporations not availed of to reduce tax

For purposes of applying the dividend look-through rule, income of a controlled foreign corporation that would otherwise be passive, financial services, or shipping income is treated as overall limitation income if it is established by the taxpayer that the income was subject to an effective foreign tax rate of greater than 90 percent of the maximum U.S. tax rate and the income is excluded from subpart F as a result under Code sec. 954(b)(4), as amended by the Act (discussed at C.1.a., below). This provision helps harmonize the operation of the subpart F and separate limitation look-through rules. Applying this coordinating provision to income that would otherwise be passive or shipping income, in particular, may eliminate the need to apply the dividend look-through rule in many cases since income of a controlled foreign corporation cannot be passive or shipping income unless it is income of a kind which is subpart F foreign personal holding company or foreign base company shipping income, respectively.

This rule relating to section 954(b)(4) income applies to lower-tier as well as to first-tier controlled foreign corporations. That is, if income of a lower-tier controlled foreign corporation is excluded from subpart F under section 954(b)(4), that income also is excluded from the passive, financial services, and shipping baskets, even if a dividend paid from that income is subpart F income to the dividend recipient's U.S. shareholders.

The Act does not coordinate section 954(b)(4)'s application with the separate limitations for high withholding tax interest and dividends from noncontrolled section 902 corporations. That is, high withholding tax interest and dividends from noncontrolled section 902 corporations that are excluded from subpart F foreign personal holding company income by section 954(b)(4) do not cease to be treated as high withholding tax interest and dividends from noncontrolled section 902 corporations, respectively. The latter separate limitation category is not closely related to any subpart F income category. If the separate limitation for high withholding tax interest were inapplicable to section 954(b)(4) income, taxpayers could circumvent that separate limitation. That separate limitation generally places high withholding taxes on interest in a separate basket where they may not be used to shelter low-taxed income from U.S. tax. If that separate limitation were inapplicable to section 954(b)(4) interest subject to high withholding tax, then U.S. shareholders of controlled foreign corporations receiving such interest could generally place it, and the associated taxes, in the overall basket with potentially low-taxed income by applying section 954(b)(4). A similar concern arises in the case of dividends from noncontrolled section 902 corporations.

The section 954(b)(4) coordination provision does not apply for purposes of the look-through rule for interest, rents, and royalties, since those amounts are typically not subject to net tax in the hands of the payor and the 90-percent test applies on a net income basis.

If a controlled foreign corporation applies section 954(b)(4) to high withholding tax interest or to dividends from a noncontrolled section 902 corporation and the controlled foreign corporation qualifies for the subpart F de minimis exception for the year, the income remains high withholding tax interest or separate limitation dividend income (as the case may be) for look-through purposes.

Examples

The following examples illustrate further how the look-through rules apply in certain cases. These examples show, in particular, the interaction of the look-through rules, on the one hand, and the subpart F de minimis and 70-percent full inclusion provisions and exception for corporations not availed of to reduce tax, on the other.

Example 1

Assume that a foreign corporation wholly owned by a U.S. corporation earns $100. Seventy-five dollars is foreign base company shipping income and $25 is nonsubpart F services income. (For simplicity, this example assumes that net income and gross income are equal.) The $75 of shipping income includes $10 of rental income that also meets the subpart F definition of foreign personal holding company income. That $10 is treated as shipping income, not passive income, under the Act. Under the 70-percent full inclusion rule of subpart F, the entire $100 is foreign base company income currently taxable to the U.S. parent. Since $75 of the $100 subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for shipping income, $75 of the subpart F inclusion is treated as separate limitation shipping income of the parent. The remaining $25 of the subpart F inclusion is treated as overall limitation income of the parent.

Example 2

Assume that a foreign corporation wholly owned by a U.S. corporation earns $100 of gross income. Four dollars is portfolio interest (which is subpart F foreign personal holding company-type income) and $96 is gross manufacturing income (which is nonsubpart F income). Among the foreign corporation's expenses is $10 of interest paid to its U.S. parent. Because the subpart F de minimis exception applies, the $4 of portfolio interest is not taxed currently to the parent. For the same reason, all of the foreign corporation's income is overall limitation income. Under the look-through rule for interest then, the full $10 interest payment is overall limitation income to the U.S. parent. To the extent any future dividends are attributable to this year's earnings and profits, they will be 100-percent overall limitation income, notwithstanding the $4 of portfolio interest.

Example 3

Assume that a foreign corporation wholly owned by a U.S. corporation earns $100. Fifty dollars is shipping income of a type that is normally foreign base company shipping income. The other $50 is dividends from a second foreign corporation in which the first foreign corporation holds 45 percent of the voting stock. Foreign persons hold the other 55 percent of the voting stock of the second foreign corporation. The second foreign corporation and the controlled foreign corporation are incorporated in different countries. The dividends received by the controlled foreign corporation are, therefore, of a type that would normally be subpart F foreign personal holding company income. However, these dividends are subject to the separate limitation for dividends from noncontrolled section 902 corporations, rather than to that for passive income (see discussion of this priority rule in the description of the former separate limitation, above).

The dividends and the shipping income are taxed abroad by the controlled foreign corporation's country only, at an effective rate of 40 percent. (This example assumes, for simplicity, that net income and gross income are equal.) Pursuant to Code section 954(b)(4) (as amended by the Act), the U.S. parent establishes to the satisfaction of the Secretary that that effective rate exceeds 90 percent of the maximum U.S. tax rate. Therefore, neither the shipping income nor the dividends are taxed currently to the U.S. parent under subpart F.

However, the controlled foreign corporation pays all its earnings and profits for the year out as a dividend. Half of that dividend is attributable to its shipping earnings and half to the dividends it received. The half of the dividend attributable to the dividends it received is subject to the separate limitation for dividends from noncontrolled section 902 corporations in the U.S. parent's hands; the Act provision conforming certain of the separate limitation rules with the section 954(b)(4) exception does not apply to that separate limitation. The other half of the dividend is overall limitation income in the parent's hands because the conforming provision just noted treats the shipping income as overall limitation for purposes of applying the look-through rule for dividends.

Payments by other entities

The Act generally treats foreign source dividends, interest, rents, and royalties from entities in which the recipient has less than a 10-percent ownership interest the same as if such payments were received from unrelated parties (that is, no look-through rules apply). Interest, rents, and royalties received from entities in which U.S. persons have no more than a 50-percent interest by 10-percent or greater U.S. owners of such entities generally are treated the same way. Thus, interest, for example, paid by foreign corporations that are not controlled foreign corporations to their U.S. shareholders is treated under the Act as separate limitation passive income, subject to the Act's high-tax kick-out.

Congress provided this treatment because of a concern that any other rule would permit abuse of the foreign tax credit system. For instance, assume that a U.S. corporation owns 45 percent of a noncontrolled section 902 manufacturing corporation organized and operating in a high-tax foreign country. The foreign corporation pays the U.S. corporation a dividend that is fully sheltered from U.S. tax by deemed-paid foreign tax credits. In addition, $17 of excess foreign tax credits are associated with the dividend. Assume that the U.S. corporation lends $400 to the foreign corporation, which it reinvests in a bank account at a slight profit. The foreign corporation pays $40 of interest to the U.S. corporation. If the Act allowed cross-crediting of the foreign taxes on the dividend against U.S. tax on the interest payment, the $17 of excess credits from the dividend would be credited against the $13.60 of pre-credit U.S. tax (at a 34-percent rate) on the interest income, leaving no residual U.S. tax on the interest income and a $3.40 excess credit to carry over. Congress did not believe that such cross-crediting was appropriate. In the case of a controlled foreign corporation, by contrast, a look-through rule treats interest payments from a controlled foreign corporation as first carrying out the payor's passive income (*see* discussion of direct allocation rule above).

In the following limited situations, the look-through rules apply to inclusions with respect to minority U.S.-owned entities. They apply to inclusions with respect to more-than-25-percent U.S.-owned insurance companies that are controlled foreign corporations under Code section 957(b), as amended by the Act (discussed at C.1.a., below), and inclusions with respect to captive insurance companies with dispersed U.S. ownership that are controlled foreign corporations under new Code section 953(c) (discussed at C.1.a., below). Application of the look-through rules here preserves general conformity of the subpart F and look-through rules. Congress believed that such application would not prove administratively burdensome; Congress was informed that most of the offshore insurance companies likely to be affected would not have income in more than one basket.

The Act requires the Secretary to prescribe such regulations as may be necessary or appropriate providing that a look-through rule similar to that applicable to interest, rents, and royalties paid by controlled foreign corporations will apply to such amounts received or accrued from entities which would be controlled foreign corporations if they were foreign corporations. Thus, under regulations, Congress anticipated that interest, rents, and royalties received by 10-percent U.S. interest holders in noncorporate entities more-than-50-percent controlled by U.S. persons would generally be subject to look-through treatment. It was also expected that foreign source interest received from more-than-50-percent U.S.-owned 80/20 companies (*see* Code sec. 861(a)(1)(B), as amended by the Act; discussion at B.4.a., below) by their 10-percent U.S. shareholders would be subject to look-through treatment under regulations.

Other rules relating to new separate limitations

The Act requires the Secretary to prescribe such regulations as may be necessary or appropriate for purposes of the separate limitation rules, including regulations for the application of the look-through rules in the case of income paid, or loans made, through one or more entities or between two or more chains of entities. For example, a controlled foreign corporation may receive interest subject to a high foreign withholding tax from a related controlled foreign corporation. To the extent necessary to preserve the integrity of the separate limitations, such interest will be characterized as passive income, financial services income, shipping income, high withholding tax interest, or dividend income from a noncontrolled section 902 corporation for separate limitation purposes by applying the look-through rule for interest to the income of the related controlled foreign corporation. That look-through rule requires a determination of the extent to which the interest is properly allocable to the related controlled foreign corporation's passive income, financial services income, shipping income, high withholding tax interest, or dividend income from a noncontrolled section 902 corporation. This grant of regulatory authority extends to the look-through rules for dividends, rents, royalties, and subpart F inclusions as well.

The Act authorizes regulations pertaining to loans so that the Secretary may prevent taxpayers from avoiding the separate limitations through the use of related party loans. Assume, for example, that a controlled foreign corporation earns $100 of low-taxed, nonsubpart F income subject to the separate limitation for financial services income. Its U.S. parent wishes to bring the $100 home. The parent would like to characterize the $100 as overall limitation income because it has excess foreign tax credits in the overall basket that would shelter the $100, if so characterized, from U.S. tax. The parent controls another foreign corporation engaged solely in manufacturing, all of the income of which is overall limitation income. The first controlled foreign corporation lends the manufacturing subsidiary $100. The manufacturing subsidiary in turn pays the U.S. parent a $100 dividend. If the general look-through rule for dividends is applied without modification, that $100 is overall limitation income to the parent. If that result were allowed to stand, however, the parent would have effectively brought home, converted into overall limitation income, the first controlled foreign corporation's $100 of financial services income. Regulations are to prevent such avoidance of the separate limitations using related party loans.

Any gain on the sale of shares in a foreign investment company that is treated as ordinary income under Code section 1246 is not a dividend for look-through purposes under the Act. Instead, it is treated as passive income. Consistent with prior law, distributions of income previously taxed under subpart F are not taxed as dividends for look-through purposes (*see* Code sec. 959(d)). As under the Code generally, a dividend for look-through purposes includes any amount treated as such under Code section 1248.

For purposes of applying the look-through rules, a U.S. corporation's income "gross-up" for deemed-paid foreign taxes (Code sec. 78) is treated as increasing the corporation's subpart F inclusion (under Code sec. 951(a)(1)(A)) to the extent that the gross-up is attributable to such a subpart F inclusion. To the extent that the gross-up is attributable to a dividend or a section 956 inclusion, the gross-up is treated as a dividend for look-through purposes. Under this approach, for example, a single $100 inclusion consisting of $80 of subpart F foreign personal holding company income and a $20 gross-up for the foreign taxes deemed paid on the $80 is subject to one look-through rule (that for subpart F inclusions under Code section 951(a)(1)(A)) rather than two (the subpart F *and* dividend look-through rules).

The Act clarifies that the deemed-paid credit limitation rules (sec. 902) and the subpart F deemed-paid credit limitation rules (sec. 960), as well as the general foreign tax credit limitation rules (secs. 904)(a)-(c)), apply separately to categories of income subject to separate limitations. Congress anticipated that regulations would prescribe rules for determining the amount of foreign taxes considered paid for separate limitation purposes with respect to particular separate limitation passive, financial services, or shipping income or separate limitation high withholding tax interest or dividends from noncontrolled section 902 corporations. To insure that the new separate limitations limit averaging as intended, the regulations will provide appropriate rules prohibiting the allocation to income subject to a particular separate limitation of foreign taxes that can be traced to other income. Congress anticipated that the regulations would be patterned generally after regulations in effect when the Act was passed that set forth rules for determining the amount of foreign taxes considered paid with respect to separate limitation passive interest (Treas. Reg. sec. 1.904-4(d)(2)) and foreign oil related income and foreign oil and gas extraction income (Treas. Reg. sec. 1.907(c)-(3)).

Effective date

In general

The new foreign tax credit rules described above generally apply to taxable years beginning after 1986. In Notice 87-6 (1987-3 I.R.B. 8), the IRS announced rules (to be incorporated in regulations) with respect to, among other things: (1) the effective date of these new foreign tax credit rules generally; (2) the characterization for separate limitation purposes of distributions and section 956 inclusions out of earnings and profits of a foreign corporation accumulated in a taxable year beginning before 1987, during taxable years of both the payor and recipient beginning after 1986, and the application of the rules for characterizing associated taxes paid or accrued by a foreign corporation; and (3) the application of the look-through rules to distributions (including deemed distributions) and payments by a foreign corporation to a recipient during a taxable year of either the payor or the recipient that begins after 1986, and a taxable year of the other that begins after 1987.

Transitional rule for high withholding tax interest

In the case of the new separate limitation for high withholding tax interest, a transitional rule is provided. Subject to certain limitations described below, the separate limitation for high withholding tax interest does not apply to interest received or accrued by any taxpayer during any taxable year beginning after 1986 and before 1990 on any "pre-1990 qualified loan." Transitional relief continues for interest received or accrued during the 5-taxable year period commencing with a taxpayer's first taxable year beginning after 1989, but is phased out during that period. Eighty percent of interest received or accrued in such first taxable year on a "post-1989 qualified loan" is not high withholding tax interest and 80 percent of the associated taxes are excluded from the high withholding tax basket. The percentage of interest on a post-1989 qualified loan that is not high withholding tax interest in the second taxable year beginning after 1989 is 60; in the third taxable year is 40; in the fourth taxable year is 20; and in the fifth and succeeding taxable years is zero.

The term "pre-1990 qualified loan" means, with respect to any taxable year beginning before 1990, any qualified loan outstanding at any time during that taxable year to the extent that the total amount of foreign taxes which would be creditable (without regard to the new foreign tax credit limitation rules) with respect to all qualified loans outstanding at any time during that taxable year does not exceed the "applicable credit limit" for that taxable year. The term "post-1989 qualified loan" means any qualified loan outstanding as of the close of the 1st taxable year of the taxpayer beginning after 1988, to the extent that the total amount of foreign taxes which would be creditable (without regard to the new foreign tax credit limitation rules) with respect to all qualified loans outstanding as of the close of that taxable year does not exceed the "applicable credit limit" for post-1989 qualified loans. Interest on a new loan entered into after 1989 will not be entitled to transition relief. For purposes of determining what constitutes a new loan, Congress intended the standard of Code section 1001 to apply.

A qualified loan generally is any loan made by the taxpayer to any of the following 33 countries or any resident of any such country for use in such country: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, Guyana, Honduras, the Ivory Coast, Jamaica, Liberia, Madagascar, Malawi, Mexico, Morocco, Mozambique, Niger, Nigeria, Panama, Peru, the Philippines, Romania, Senegal, Sierra Leone, the Sudan, Togo, Uruguay, Venezuela, Yugoslavia, Zaire, and Zambia. The credit-based limitation described below will, in certain circumstances, reclassify qualified loans as non-qualified loans. Specifically, if the foreign taxes creditable for any taxable year beginning before January 1, 1990, with respect to any qualified loan, when added to the aggregate amount of foreign taxes creditable for that taxable year with respect to qualified loans entered into by the taxpayer before the date on which that qualified loan was entered into, exceed the "applicable credit limit," then that portion of a qualified loan which causes the taxpayer to exceed the "applicable credit limit" is not to be treated as a pre-1990 or post-1989 qualified loan, as the case may be. Qualified loans held by a taxpayer are to be classified as non-qualified loans pursuant to a last in first out method, beginning with the qualified loan most recently entered into by the taxpayer. Beginning in 1990, all loans will have been classified as post-1989 qualified loans or non-qualified loans.

In the case of pre-1989 qualified loans, the "applicable credit limit" equals: 110 percent of the product of the "base credit amount" and the "applicable interest rate adjustment" for the first taxable year. In the case of post-1989 qualified loans, the applicable credit limit is the amount just calculated (without regard to the interest rate adjustment) multiplied by the interest rate adjustment for post-1989 qualified loans.

With respect to a given taxpayer, the "base credit amount" equals the principal amount of qualified loans held by the taxpayer on November 16, 1985, multiplied by the interest rate applicable to that loan on November 16, 1985, multiplied by the foreign withholding tax rate applicable to interest payable with respect to that loan on November 16, 1985. The base credit amount is to be computed, and the transitional rule applied, on a consolidated group basis for companies that join in filing a consolidated return.

The "applicable interest rate adjustment" equals the ratio of the weighted average bi-monthly London Interbank Offered Rate (LIBOR) for the taxable year in question to LIBOR on November 15, 1985. In the case of post-1989 qualified loans, the applicable interest rate adjustment equals the ratio of LIBOR on the last day of the taxpayer's first taxable year beginning after 1988 to LIBOR on November 15, 1985. Congress understood that the 11 a.m. 6-month LIBOR quoted by a major bank on November 15, 1985, was 8¼ percent and intended that this rate apply for purposes of the transitional rule.

The transitional rule applies to qualifying interest received or accrued by U.S. persons. It also generally applies to qualifying interest received or accrued by controlled foreign corporations, for purposes of determining the separate limitation character under the look-through rules of certain income with respect to such corporations. A 10-percent U.S. shareholder of a controlled foreign corporation is to benefit from the transitional rule's application to interest received or accrued by that foreign corporation only to the extent that that shareholder was also a 10-percent U.S. shareholder of the corporation on November 16, 1985. The transitional rule generally applies as well to foreign taxes on qualifying interest received or accrued by noncontrolled section 902 corporations that would otherwise be subject to the Act's special creditability rule for such taxes. A 10-percent U.S. shareholder of a noncontrolled section 902 corporation may benefit from the transitional rule's application to foreign taxes imposed on that corporation only to the extent that that shareholder was also a 10-percent U.S. shareholder of the corporation on November 16, 1985.

No relief is allowed by reason of the transitional rule for any foreign tax imposed on interest payable with respect to any qualified loan to the extent that the rate of such tax exceeds the foreign withholding tax rate applicable to interest payable with respect to such loan on November 16, 1985. This rule was intended to prevent taxpayers from deriving benefits under the transitional rule from foreign withholding tax rates that have increased since November 16, 1985. For example, if a foreign country doubles its withholding tax rate applicable to a qualified loan over the rate applicable on November 16, 1985, then 50 percent of the interest earned with respect to such loan will not be eligible for transitional relief.

Interest to which the transitional rule applies is passive income (subject to the high-tax kick-out, and the other exceptions to the separate limitation for passive income) unless received by an entity predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In the latter case, under the predominantly engaged test, such interest is subject to the separate limitation for financial services income.

Limited transitional rule for passive income

A targeted transitional rule relating to the separate limitation for passive income is provided.

Excess credit carryforwards

Under the Act, foreign tax credit carryforwards allowed for foreign taxes paid in pre-effective date taxable years generally reduce the U.S. tax in post-effective date taxable years on income of the same limitation type as the income on which the carried forward taxes were imposed. For example, foreign tax credit carryforwards to a post-effective date taxable year that are allowed for foreign taxes paid in pre-effective date taxable years on portfolio dividends then subject to the overall limitation generally are only to reduce the U.S. tax on overall limitation income (as defined after the effective date). Similarly, carryforwards from the prior law basket for interest are to reduce U.S. tax on post-effective date passive income. However, the Act provides that pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on shipping income to the extent that the taxpayer establishes to the satisfaction of the Secretary that the overall limitation income on which the taxes were paid would have been classified as shipping income had it been earned after the Act's effective date. Similarly, the Act provides that pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on financial services income to the extent that the taxpayer establishes to the satisfaction of the Secretary that the overall limitation income on which the taxes were paid would have been classified as financial services income had it been earned after the Act's effective date. The latter rule applies only to taxes paid by entities predominantly engaged in the active conduct of a banking, insurance, financing or similar business in both the carry-from and the carry-to year. It does not apply to taxes paid on income that would have been classified as high withholding tax interest had it been earned after the Act's effective date.

Excess credit carrybacks

Post-effective date carrybacks from any basket to pre-effective date taxable years may reduce the U.S. tax on overall limitation income only. The amount of any post-effective date carryback is limited to the amount of such carryback that would have arisen, other things equal, if the tax rates in effect in the year to which the tax is carried back were the tax rates applicable in the year in which the carryback arises. This rule is necessary to prevent taxpayers from effectively obtaining the benefit of the Act's rate reductions for earlier years in which tax rates were higher. Under regulations prescribed by the Secretary, proper adjustments are to be made in the application of this rule to take into account the repeal of the zero bracket amount and the changes in the treatment of capital gains. Post-effective date excess credits for high withholding taxes on interest may not be carried back to pre-effective date years. The latter rule is necessary because the carryback of such credits to offset the U.S. tax on pre-effective date overall limitation income would defeat the purpose of the separate limitation for high withholding tax interest.

3. Deemed-paid credit

For purposes of computing the deemed-paid foreign tax credit, dividends or subpart F inclusions are considered made first from the post-1986 pool of all the distributing corporation's accumulated earnings and profits. Accumulated earnings and profits for this purpose include the earnings and profits of the current year undiminished by the current distribution or subpart F inclusion. The rule treating actual distributions made in the first 60 days of a taxable year as made from the prior year's accumulated profits is repealed. A dividend or subpart F inclusion is considered to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary on or with respect to the accumulated earnings in the pool.

Earnings and profits computations for these purposes are to be made under rules similar to those required under prior law for subpart F deemed dividends (and permitted for actual distributions). However, the rules for translating foreign currency are modified. (*See* F., below.)

Pooling applies prospectively only. Dividends are treated as paid first out of the pool of all accumulated profits derived by the payor after the effective date. Dividends in excess of that accumulated pool of post-effective date earnings and profits are treated as paid out of pre-effective date accumulated profits under the ordering principles of prior law.

If a dividend is paid from a lower-tier to an upper-tier foreign subsidiary, it was intended that the general provisions of prior law continue to apply to determine the year in which the dividend is included in the earnings and profits of the recipient. For example, a post-effective date dividend paid by a second-tier foreign subsidiary to a first-tier foreign subsidiary out of pre-effective date earnings and profits is treated as increasing the earnings and profits of the recipient in the year of the dividend for purposes of later calculating the deemed-paid credit of recipients of distributions paid by the upper-tier subsidiary. Thus, the earnings and profits of the upper-tier subsidiary attributable to that dividend will be subject to pooling when repatriated. However, to determine the amount of the foreign taxes associated with that dividend and paid by the lower-tier subsidiary which will go into the pool for this purpose, the pre-effective date section 902 rules are applied to the dividend and the pre-effective date earnings from which it was paid.

In the case of a foreign corporation that does not have a 10-percent (direct or indirect) U.S. shareholder who qualifies for the deemed-paid credit, as of the first taxable year the Act is generally effective, pooling begins with the first day of the first taxable year thereafter in which there is such a 10-percent shareholder.

The pooling provisions of the Act apply only for purposes of determining the deemed-paid foreign tax credit. For example, there is no change in the prior law provision that a subpart F inclusion from a lower-tier foreign subsidiary is included directly in the U.S. shareholder's income without passing through any upper-tier foreign corporation. Also, the pooling provisions do not change the provisions limiting to current earnings and profits the amount that can be treated as a current subpart F inclusion to a controlled foreign corporation's shareholders. The pooling provisions do not change the computation of earnings and profits and the treatment of deficits for purposes of determining the amount of a subpart F inclusion or a dividend. For example, if in 1987 a foreign subsidiary wholly owned by a U.S. parent is established and incurs a $100 deficit with respect to a category of income and in 1988 the subsidiary has $50 of earnings and profits attributable to subpart F income in that same category, the parent may have no subpart F inclusion for 1988 due to the accumulated deficit (sec. 952(c), as modified by the Act; see discussion of the amendments to sec. 952(c) at C.1.a., below). On the other hand, if the subsidiary made a $50 distribution to its U.S. parent in 1988, the U.S. parent would have a $50 dividend in 1988 due to the presence of $50 of earnings and profits for that year (sec. 316(a)(2)). However, because of the accumulated deficit in the 2-year pool of post-effective date earnings, no deemed-paid credit would be available with respect to the 1988 dividend.

The deemed-paid credit with respect to a subpart F inclusion generally is determined on a pooling basis under the Act in order to limit opportunities to avoid the effect of pooling by creating subpart F inclusions. However, the Act grants the Secretary limited regulatory authority, in the case of subpart F inclusions, to modify the pooling method for computing the deemed-paid credit. This grant of regulatory authority was provided primarily to permit the IRS to address certain technical difficulties which it believed might arise in implementing the pooling rules with respect to subpart F inclusions *other than* those for increases in earnings invested in U.S. property.

The Act requires the Secretary to provide such regulations as may be necessary or appropriate to carry out the deemed-paid credit and subpart F deemed-paid credit provisions, including rules which provide for the separate application of those provisions to reflect the separate application of the foreign tax credit limitation to separate types of income and loss. As discussed above (at A.2.), Congress anticipated that regulations would prescribe rules for determining the amount of foreign taxes considered paid for separate limitation purposes with respect to separate limitation income. To implement the intent that the deemed-paid credit limitation rules apply separately to categories of income subject to separate limitations, separate pools of earnings and profits and of foreign taxes must be maintained for the types of income subject to separate limitations. Thus, for example, as discussed above, once it has been determined that there are sufficient earnings and profits to cause a subpart F inclusion, the subpart F inclusion itself (if not attributable to investment in U.S. property) will be characterized in accordance with the separate limitation or overall limitation character of the income to which it is attributable. The subpart F deemed-paid credit, with respect to any separate limitation passive income or other separate limitation income, is then determined by reference to the pool of the applicable separate limitation accumulated profits and related taxes, and the subpart F deemed-paid credit with respect to any overall limitation income is determined by reference to the pool of overall limitation accumulated profits and related taxes. In the case of a subpart F inclusion attributable to investments of earnings in U.S. property (under section 956), or in the case of a dividend, the separate limitation character of the inclusion or dividend is determined under somewhat different look-through rules. (See discussion of separate limitations and related look-through rules above.) Once that determination has been made, again, the deemed-paid credit with respect to separate limitation or overall limitation income is determined by reference to the pools of accumulated profits and taxes attributable to that limitation category of income. The principles of the foreign loss rules and related recharacterization provisions discussed below also are applied in determining the separate limitation and overall limitation accumulated profits of foreign corporations for these purposes.

Congress also anticipated that the Secretary would exercise his regulatory authority to ensure that, if subpart F income is in fact subject to little or no foreign tax, then the amount of the foreign tax credit determined under section 960 with regard to such income will properly reflect that fact.

Effective date

The amendments to the deemed-paid credit just described apply to distributions by foreign corporations out of, and to subpart F inclusions attributable to, earnings and profits for taxable years beginning after December 31, 1986. Distributions and subpart F inclusions in taxable years beginning after December 31, 1986 are generally treated as made out of the pool of earnings for such years, to the extent thereof. With the repeal of the 60-day rule, for example, a dividend paid on February 1, 1987, by a calendar year foreign corporation is treated as made first out of the payor's post-1986 pool of earnings. If the first taxable year in which there is a 10-percent U.S. shareholder who would qualify for the deemed-paid credit begins after 1986, then such taxable year is substituted for the first taxable year beginning after December 31, 1986.

4. Foreign losses

The Act provides that, for foreign tax credit limitation purposes, losses for any taxable year in separate foreign tax credit limitation "baskets" and in the overall limitation basket offset U.S. source income only to the extent that the aggregate amount of such losses exceeds the aggregate amount of foreign income earned in other baskets. These losses (to the extent that they do not exceed foreign income for the year) are to be allocated on a proportionate basis among (and operate to reduce) the foreign income baskets in which the entity earns income in the loss year. Losses in all separate limitation baskets (enumerated in Code sec. 904(d)(1), as amended by the Act), including the passive, financial services, shipping, and high withholding tax interest income baskets and the baskets for dividends from noncontrolled section 902 corporations, are subject to this rule.

A separate limitation loss recharacterization rule applies to foreign losses allocated to foreign income pursuant to the above rule. The recharacterization rule is similar to the overall foreign extraction loss recapture rule of present and prior law (Code sec. 907(c)(4)). If a separate limitation loss or an overall limitation loss was allocated to income subject to another separate limitation (or, in the case of a separate limitation loss, to overall limitation income) and the loss basket has income for a subsequent taxable year, then that income (to the extent that it does not exceed the aggregate separate limitation losses in the loss basket not previously recharacterized under this provision) must be recharacterized as income previously offset by the loss in proportion to the prior loss allocation not previously taken into account under this provision.

To the extent that that prior loss allocation, by reducing (for limitation purposes) foreign income that was subject to high foreign taxes, gave rise to additional excess foreign tax credits, the subsequent treatment of additional income as if it were such high tax foreign income may increase the foreign tax credit limitation in the year or years when the recharacterization occurs. To the extent that the loss allocation, by reducing (for limitation purposes) income that bore little or no foreign tax, reduced post-foreign tax credit U.S. tax liability in the loss year, the subsequent treatment of additional income as income of the type that bore little foreign tax may result in a recovery of some or all of the previously foregone U.S. tax revenue in the year or years when the recharacterization occurs. The 50-percent limitation on the amount subject to recapture under present and prior law's overall foreign loss recapture rule (Code sec. 904(f)(1)(B)) does not apply in determining the amount subject to recapture under the new recharacterization provision.

The following is an example of how the Act's foreign loss allocation and separate limitation loss recharacterization provisions operate: Assume a U.S. corporation earns $200 of U.S. income, $20 of foreign income subject to the separate limitation for passive income, and $5 of foreign income subject to the separate limitation for certain distributions from FSC in a taxable year. The corporation also incurs a $10 overall limitation loss in that taxable year. Under the Act's foreign loss allocation rule, the $10 overall limitation loss is allocated on a proportionate basis among the foreign income baskets in which the corporation earns income in the loss year. Thus, $8 of that loss is allocated to its $20 of passive income and the remaining $2 of the loss is allocated to its $5 of FSC distributions. None of the loss is allocated to its $200 of U.S. income. Thus, for foreign tax credit limitation purposes, the corporation has $12 of passive basket income, $3 of income in the FSC distribution basket, and $200 of U.S. income for the taxable year.

In the following taxable year, the corporation earns $25 of passive basket income, $5 of income in the FSC distribution basket, and $50 of overall limitation income. Because the corporation had a $10 overall limitation loss in the previous year that was allocated to separate limitation income in that year, $10 of its $50 of overall limitation income is recharacterized under the Act's separate limitation loss recharacterization rule as income of the type previously offset by that loss. That recharacterization is in proportion to the prior loss allocation. Thus, $8 of the overall limitation income is recharacterized as passive basket income and $2 of the overall limitation income is recharacterized as income in the FSC distributions basket. Thus, for foreign tax credit limitation purposes, the corporation has $33 of passive basket income, $7 of income in the FSC distributions basket, and $40 of overall limitation income in the second taxable year.

Congress intended that, where a loss is incurred in more than one foreign income basket in a particular year, each such loss be allocated proportionately to foreign income, and then to U.S. income. For example, assume that a U.S. corporation earns $200 of U.S. income and $20 of passive foreign income. The corporation also incurs a $20 overall limitation loss and a $5 shipping basket loss. Under the foreign loss allocation rule, the $20 and $5 separate limitation losses are to be allocated first to the $20 of passive income; only after that allocation is any portion of either separate limitation loss allocated to U.S. income. Each separate limitation loss must be allocated to foreign income in proportion to the ratio of total foreign income to total foreign loss. Thus, $16 of the $20 overall limitation loss ($20 x $20/$25) reduces the $20 of passive income and $4 of the $5 shipping basket loss ($5 x $20/$25) reduces the $20 of passive income. The remaining $4 of overall limitation loss and $1 of shipping basket loss reduce the $200 of U.S. income. For the year, then, the corporation has $195 of U.S. income and no foreign income for foreign tax credit limitation purposes. If the corporation earns sufficient overall limitation income in a later year, then, after application of the foreign loss recapture rule of present and prior law (Code sec. 904(f)), $16 of such income will be subject to recharacterization as passive income. If the corporation earns shipping income in a later year, then, after application of the foreign loss recapture rule, $4 of such income will be subject to recharacterization as passive income.

The Act's foreign loss allocation and separate limitation loss recharacterization rules apply to foreign persons to which the Act's separate limitation look-through rules apply, as well as to U.S. persons. The Act requires the IRS to prescribe such regulations as may be necessary or appropriate for purposes of the separate limitations, including regulations for the application of the foreign loss allocation and separate limitation loss recharacterization rules in the case of income paid through one or more entities or between two or more chains of entities.

Foreign taxes on income recharacterized under the separate limitation loss recharacterization rule are not themselves to be recharacterized. For example, foreign taxes on overall limitation income that is recharacterized as separate limitation income in a year following an overall limitation loss year may be credited only against U.S. tax on other overall limitation income.

The foreign loss allocation and recharacterization rules apply on an affiliated group basis in the case of an affiliated group filing a consolidated tax return. If no foreign loss has been sustained in the case of an affiliated group of corporations filing a consolidated return, then no such loss is subject to recharacterization even if a member of the group had such a loss and the member is subsequently sold or otherwise leaves the group.

For purposes of the Act's foreign loss allocation and separate limitation loss recharacterization provisions, the amount of a loss in a separate limitation basket or in the overall limitation basket is determined under the principles of the present and prior law provision that defines foreign oil and gas extraction losses for purposes of the overall foreign extraction loss recapture rule (Code sec. 907(c)(4)(B)). Thus, a loss in the separate limitation basket or the overall limitation basket is the amount by which the taxpayer's (or in the case of an affiliated group filing a consolidated return, the group's) gross income from activities giving rise to income in that basket is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to that income and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (under Code sec. 862(b) or 863). In computing the amount of a foreign loss for these purposes, the net operating loss deduction (under Code sec. 172(a)) is not to be taken into account. For purposes of these provisions, a taxpayer is to be treated as sustaining a foreign loss whether or not the taxpayer claims a foreign tax credit for the year of the loss.

Congress intended that the foreign loss allocation and recharacterization rules apply to net operating loss ("NOL") carryovers. Congress indicated that it expected the Secretary to issue regulations adapting the new rules as necessary for this purpose.

The following example illustrates how the foreign loss allocation and recharacterization rules apply in cases involving NOL carryovers: Assume that a U.S. corporation which operates primarily abroad incurs a $200 NOL. The loss is attributable to foreign activities that would generate overall limitation income. In the following year, the corporation earns $180 of overall limitation income and $30 of income subject to the separate limitation for passive income. The corporation carries the prior year's $200 NOL forward. Under the foreign loss allocation rule, the NOL offsets the $180 of overall limitation first, since the NOL arose in the overall limitation category. The remaining $20 of the loss reduces (to $10) the corporation's passive income.

In the next year, the corporation earns $220 of overall limitation income. Under the foreign loss recharacterization rule, $20 of this overall limitation income is recharacterized as passive income because $20 of passive income was offset by the overall limitation NOL in the preceding year. Thus, for foreign tax credit limitation purposes, the corporation has $200 of overall limitation income and $20 of passive income for the year.

Congress indicated that it expected the regulations implementing the foreign loss allocation and recharacterization rules to apply the latter rule to an entity that is a successor entity to one that benefitted from the former rule.

In cases where a taxpayer realizes an overall foreign loss, both the overall foreign loss recapture rule of present and prior law (Code sec. 904(f)) and the separate limitation loss recharacterization rule apply. For example, if a U.S. corporation has a loss in the overall limitation basket of $100, $75 of separate limitation foreign income, and $100 of U.S. income, the $100 loss first offsets the $75 of separate limitation foreign income (under the Act's foreign loss allocation rule) and then offsets $25 of U.S. income. If, in a subsequent year, the corporation has $100 of overall limitation income, the prior year's $100 loss first is used to recharacterize $25 of that income as U.S. income under the overall foreign loss recapture rule, and then is used to recharacterize the remaining $75 of that income as separate limitation income under the separate limitation loss recharacterization rule.

In light of the new foreign loss allocation and recharacterization rules, Congress believed that one aspect of the application of the overall foreign loss recapture rule of existing law should be clarified. Congress intended that foreign income earned in a year following an overall foreign loss year be recharacterized as U.S. income under the overall foreign loss recapture rule only to the extent that that foreign income is of the same limitation type as the previous loss. For example, assume that a U.S. corporation incurs a $100 overall limitation loss and earns $300 of U.S. income in a taxable year. The full $100 loss is an overall foreign loss subject to recapture in a later year because U.S. income is offset by the full amount of the loss. In the following taxable year, the taxpayer earns $50 of overall limitation income, $150 of passive limitation income, and $250 of U.S. income. Congress intended that the 50-percent limitation (sec. 904(f)(1)(B)) on the amount of foreign income that must be recharacterized as U.S. income in a taxable year be applied to the full amount of the corporation's foreign income, $200, as it would have been under prior law. Thus, up to $100 of foreign income can be recharacterized as U.S. income under the 50-percent limitation. However, the corporation has only $50 of income of the same limitation type (overall) as the prior year foreign loss. Only that $50 then is to be recharacterized as U.S. income under the overall foreign loss recapture rule. Thus, for foreign tax credit limitation purposes, the corporation has $150 of passive limitation income, $300 of U.S. income, and no overall limitation income for the taxable year. Up to $50 of overall limitation income earned in a subsequent year will be subject to recapture because only $50 of the $100 overall foreign loss incurred in the first taxable year has been recaptured.

Effective date

The amendments relating to foreign losses apply to losses incurred in taxable years beginning after December 31, 1986.

5. U.S. losses

The Act provides that any U.S. loss for any taxable year is allocated among (and operates to reduce) foreign income in different limitation baskets on a proportionate basis. Assume, for example, that a U.S. corporation has a $100 U.S. loss, $150 of net overall limitation income, and $50 of net passive income in a taxable year. Under the Act, $75 of the loss reduces overall limitation income and $25 of the loss reduces passive income. For foreign tax credit limitation purposes then, the corporation has $75 of overall limitation income and $25 of passive income for the taxable year.

This rule applies after any foreign losses have been allocated among the foreign income baskets in which the taxpayer earns income.

The following example illustrates how the new U.S. loss allocation rule, on the one hand, and the foreign loss allocation and recharacterization rules, on the other, operate in relation to one another.

Assume that a U.S. corporation incurs a $50 overall limitation loss abroad and a $100 U.S. loss. It also earns $600 of foreign income subject to the separate limitation for shipping income and $400 of foreign income subject to the separate limitation for passive income. The foreign loss allocation rule applies before the U.S. loss allocation rule. Under the former rule, $30 of the overall limitation loss reduces the $600 of shipping income and the remaining $20 of such loss reduces the $400 of passive income.

Before allocation of the U.S. loss, then, the U.S. corporation has $570 of shipping income and $380 of passive income. Under the Act, $60 of the U.S. loss reduces the $570 of shipping income and the remaining $40 of such loss reduces the $380 of passive income. Thus, for foreign tax credit limitation purposes, the corporation has no U.S. income, $510 of shipping income, and $340 of passive income for the year.

In the following year, the corporation incurs a $780 U.S. loss. It also earns $200 of overall limitation income and $600 of shipping income. The U.S. loss allocation rule applies before the foreign loss recharacterization rule. Under the former rule, $195 of the U.S. loss reduces the $200 of overall limitation income and the remaining $585 of such loss reduces the $600 of shipping income.

The corporation thus has no U.S. income, $5 of overall limitation income, and $15 of shipping income for the year before the application of the foreign loss recharacterization rule. Under that rule, $3 of the overall limitation income is recharacterized as shipping income and the remaining $2 of the overall limitation income is recharacterized as passive income. This recharacterization occurs because, in the prior year, $30 of shipping income and $20 of passive income were eliminated by a $50 overall limitation loss.

In the current year then, the corporation has no U.S. income, $18 of shipping income, and $2 of passive income for foreign tax credit limitation purposes. If the corporation earns overall limitation income in later years, up to $45 ($50-$5) of such income will be subject to the foreign loss recharacterization rule.

Effective date

The new U.S. loss allocation rule applies to losses incurred in taxable years beginning after December 31, 1986.

6. Subsidies

The Act also contains a provision intended to clarify and codify a rule embodied in Treas. Reg. sec. 1.901-2(e)(3). That regulation generally provides that any foreign government subsidies accorded in connection with foreign taxes reduce the creditable portion of such taxes. Under the Act, any income, war profits, or excess profits tax is not treated as a creditable tax to the extent that the amount of the tax is used, directly or indirectly, by the country imposing the tax to provide a subsidy by any means (such as through a refund or credit) to the taxpayer, a related person (within the meaning of Code sec. 482), any party to the transaction, or any party to a related transaction, and the subsidy is determined, directly or indirectly, by reference to the amount of the tax, or the base used to compute the tax.

Assume, for example, that a U.S. bank lends money to a foreign development bank. The foreign development bank relends the money to companies resident in the foreign bank's residence country. The foreign bank's residence country imposes a withholding tax on the interest that the foreign development bank pays to the U.S. bank. On the date that the tax is withheld by the foreign bank, 50 percent of the tax is credited by the levying country to an account of the foreign development bank. The levying country requires the foreign development bank to transfer the amount credited to the borrowing companies. Since the amount transferred by the levying country to the borrowing companies (through the foreign bank) is determined by reference to the amount of the tax and is a subsidy to parties to transactions that are related to the taxable transaction, the amount transferred is not treated as a creditable tax under the Act.

Congress was aware that the validity under prior law of a ruling predating Treas. Reg. sec. 1.901-2(e)(3) that embodies its substance was being challenged in litigation pending in the U.S. Tax Court. Congress indicated that no inference should be drawn from its action as to the validity or invalidity of the regulation or ruling for years prior to the effective date of the Act.

Congress' codification of Treas. Reg. sec. 1.901-2(e)(3) was not intended to modify the application of existing Treas. Reg. sec. 1.901-2(f)(2)(i), which generally treats a tax as paid by the taxpayer even if another party to a transaction with the taxpayer agrees, as part of the transaction, to assume liability for the tax. The latter regulation by its terms applies notwithstanding anything to the contrary in Treas. Reg. sec. 1.901-2(e)(3).

Congress intended that the amount of any withholding tax paid be positively established through documentation provided in accordance with the requirements of Code section 905(b) and Treas. Reg. sec. 1.905-2. In this regard, Congress emphasized that the mere fact that withholding took place does not necessarily constitute adequate proof of the amount of tax paid. Congress' concerns with respect to documentation of foreign taxes were heightened by the problem of subsidized foreign tax payments. Congress was informed that in some cases amounts withheld are retained by the withholding agent, in whole or in part, with the explicit or implicit approval of the foreign sovereign. Particularly in the case of a net loan, both payee and payor stood to benefit from a high withholding "tax" that was never paid over to the government; the payor received cash in hand (equivalent to a lower interest rate) while the payee received a foreign tax credit for a fictional tax, without any reduction in net proceeds. Although the Act, by codifying the prohibition of direct and indirect subsidies of foreign taxes, confirms that a foreign tax credit is disallowed in such cases, Congress was concerned that without a strict documentation requirement the Service would find it difficult to determine when such a subsidy had been given. Therefore, Congress indicated that it expected that a receipt or other positive proof of payment will generally be required to establish the amount of foreign withholding tax paid with respect to foreign source interest income received by U.S. taxpayers.

Effective date

The amendment relating to subsidies applies to foreign taxes paid or accrued in taxable years beginning after December 31, 1986.

Revenue Effect of Foreign Tax Credit Provisions

The provisions are estimated to increase fiscal year budget receipts by $393 million in 1987, $675 million in 1988, $677 million in 1989, $842 million in 1990, and $1,029 million in 1991.

B. Source Rules

1. Determination of source in case of sales of personal property (sec. 1211 of the Act and secs. 861, 862, 863, 864, 871, 881, and 904, and new sec. 865 of the Code)[1]

Prior Law

Overview

Rules determining the source of income are important because the United States acknowledges that foreign countries have the first right to tax foreign income, but the United States generally imposes its full tax on U.S. income. With respect to foreign persons, the source rules are primarily important in determining the income over which the United States asserts tax jurisdiction (foreign persons are subject to U.S. tax on their U.S. source income and certain foreign source income that is effectively connected with a U.S. trade or business). The United States generally taxes the worldwide income of U.S. persons and the source rules are primarily important for U.S. persons in determining their foreign tax credit limitation. A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. income, but only a taxpayer's U.S. tax on its foreign income. For the foreign tax credit mechanism to function, then, every item of income must have a source: that is, it must arise either within the United States or outside the United States.

Income derived from purchase and resale of property

Under prior law, income derived from the purchase and resale of personal property, both tangible and intangible, generally was sourced at the location where the sale occurred. The place of sale generally was deemed to be the place where title to the property passed to the purchaser (the "title passage" rule). To the extent personal property was depreciable or subject to other basis adjustments (e.g., amortization), the gain attributable to the recapture of such adjustments was also sourced on the basis of the place of sale.

One type of foreign source income derived by a foreign person that was subject to U.S. tax was the sale or exchange of inventory property if the foreign person had an office or other fixed place of business within the United States, the income was attributable to the office or other fixed place of business, and the sale or exchange was conducted through the office or other fixed place of business. This income was not, however, subject to U.S. tax if the property was sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer outside the United States materially participated in the sale. In determining whether income of a foreign person is attributable to a U.S. office or other fixed place of business within the United States, present and prior law generally disregard the office of an independent agent, require the office to be a material factor in the production of the income, and attribute to the office only the amount of income allocable to it.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 611; H.Rep. 99-426, pp. 359-365; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 911; S.Rep. 99-313, pp. 328-333; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 595-596 (Conference Report).

Income derived from manufacture and sale of property

Under present and prior law, income derived from the manufacture of products in one country and their sale in a second country is treated as having a divided source. Under Treasury regulations, half of this income generally is sourced in the country of manufacture, and half of the income is sourced on the basis of the place of sale. The division of the income between manufacturing and selling activities is required to be made on the basis of an independent factory price rather than on a 50/50 basis, if such a price exists.

Income derived from intangible property

Under present and prior law, royalty income derived from the license of intangible property generally is sourced in the country of use. For certain purposes, income derived from the sale of intangible property for an amount contingent on the use of the intangible is sourced as if it were royalty income.

Withholding on certain intangible income

Present and prior law provide that certain types of U.S. source income paid to foreign persons are subject to U.S. tax on a gross basis if they are not effectively connected with the conduct of a trade or business in the United States. This method of taxation is generally based on the premise that the foreign person does not have sufficient presence in the United States for an accurate determination of the foreign person's expenses to impose tax on a net basis.

One of these types of income is gain from the sale of certain intangible property to the extent that the payments for the intangible property are contingent on the productivity, use, or disposition of the property (sec. 871(a)(1)(D)). A related provision (sec. 871(e)) treated gain on the sale of intangible property as being contingent on the productivity, use, or disposition of the property if more than 50 percent of the gain was actually from payments which were so contingent. This related provision also treated those gains as royalties for purposes of determining their source.

Reasons for Change

Congress recognized the importance of providing appropriate source of income rules for defining U.S. tax jurisdiction. Congress believed that source rules for sales of personal property should generally reflect the location of the economic activity generating the income, taking into account the jurisdiction in which those activities are performed. With regard to foreign persons, Congress believed that prior law allowed foreign persons in certain circumstances to avoid U.S. taxation despite the presence of a fixed U.S. business by manipulating the transfer of ownership to their property. With regard to U.S. persons, Congress believed that, with the substantial reduction of U.S. tax rates provided in the Act, more U.S. taxpayers would have excess foreign tax credits and that, therefore, there would be more incentive after tax reform to generate low-taxed foreign source income to absorb the excess foreign tax credits. Congress noted that the foreign tax credit mechanism was originally established to eliminate double taxation of the same income by the United States and foreign countries. Congress did not believe that the potential for double taxation existed where income had little likelihood of attracting foreign tax. With the above in mind, Congress modified prior law's source of income rules to ensure that the United States will assert proper tax jurisdiction over the activities of foreign persons and, with respect to U.S. persons, will treat as foreign source income only that income which is generated within a foreign country and which is likely to be subject to foreign tax.

Congress recognized that prior law's source rules for income derived from sales of personal property sometimes allowed U.S. taxpayers to freely generate foreign income subject to little or no foreign tax, but was concerned that its repeal for sales of inventory property would create difficulties for U.S. businesses competing in international commerce. Moreover, with the substantial trade deficits of the United States, Congress did not want to impose any obstacles that might exacerbate the problems of U.S. competitiveness abroad. Congress was concerned with the tax policy implications of prior law, however, and directed the Treasury Department to study the source rule for sales of inventory property taking into account not only the tax policy implications of the rule but also Congress' concerns regarding the impact of this rule on U.S. trade.

In other cases where manipulation of the place-of-sale rule was relatively easy (for example, sales of portfolio stock investments), Congress did believe that the United States should assert taxing jurisdiction by reference to more meaningful criteria than under prior law. Congress realized that in cases where manipulation of source occurs, there is little likelihood that foreign countries tax this income. Congress believed in these circumstances that the residence of the seller should govern the source of the income since countries rarely tax personal property gains on a source basis. Notwithstanding this general view, Congress was concerned that a strict residence-of-the-seller rule would treat some income that properly should be foreign source as U.S. source. In this regard, Congress did not intend that income likely to be subject to foreign tax, for example, income derived from the disposition of assets used in a manufacturing operation by a U.S. corporation in a foreign country where the income is connected with that business, be treated as U.S. source. Congress believed in these circumstances that that income should be sourced in the jurisdiction in which those assets are used in order to give the first right to tax that income to a foreign country that properly exercises it.

Congress was also concerned with the application of the place-of-sale rule for foreign persons. Congress was aware that some foreign persons with U.S. businesses were able to engage in significant business operations through a fixed place of business in the United States but were able to avoid paying U.S. tax. This was accomplished through use of the place-of-sale rule to generate non-U.S. source income. Moreover, Congress was aware that some U.S. income tax treaties precluded the United States from taxing foreign source income attributable to a U.S. permanent establishment. Congress was concerned that these results eroded the U.S. tax base and believed the place-of-sale rule was not appropriate in defining U.S. tax jurisdiction in these cases. Congress recognized, however, that in certain cases other jurisdictions assert tax jurisdiction over this income. In these situations, Congress believed it appropriate to cede primary tax jurisdiction over sales income to a country asserting jurisdiction as long as the property sold is used outside the United States and the activities that generate the sales income are materially performed outside the United States.

Congress also believed that, to the extent payments from the sale of intangible property are contingent on the use of the property, the sales income is more in the nature of a royalty for the use of property than gain from an outright sale of the property. Congress believed, therefore, that the source rules governing royalties should govern this kind of income.

Explanation of Provisions

General rule

Under the Act, income derived by U.S. residents from the sale of personal property, tangible or intangible, is generally sourced in the United States. Similarly, income derived by a nonresident of the United States from the sale of personal property, tangible or intangible, is generally treated as foreign source. For purposes of this provision, the term sale includes an exchange or other disposition. For purposes of determining source, the term sale, however, does not include a disposition of intangibles to the extent payments are contingent on the productivity, use, or other disposition of the intangible. Payments that are so contingent are treated like royalties in determining their source. Intangible property for purposes of source determination is any patent, copyright, secret process or formula, trademark, trade name or other like property. Any possession of the United States is treated as a foreign country for purposes of this provision.

The Act provides that an individual is a resident of the United States for purposes of this provision if the individual has a tax home (as defined in sec. 911(d)(3)) in the United States. Any corporation, partnership, trust, or estate which is a United States person (as defined in sec. 7701(a)(30)) is a U.S. resident for this purpose. All other individuals and entities generally are nonresidents for purposes of these source rules.

Congress was aware that some of the source rules in the Act may conflict with source rules prescribed in U.S. income tax treaties. The source rules in the Act reflect Congress' policy that income not taxed, or not likely to be taxed, by a foreign country generally should not be treated as foreign source income for purposes of the foreign tax credit limitations. Congress did not intend that treaty source rules should apply in a manner which would frustrate the policy underlying the source rules in the Act that untaxed income not increase a U.S. taxpayer's foreign tax credit limitation. Congress intended this treatment for all of the Act's source rules, not only those governing sales of personal property.

Exceptions to residence rule

Income derived from the sale of inventory property

The Act retains prior law's place-of-sale rule for sourcing income derived from the disposition of inventory property. Inventory property for this purpose is defined as under prior law (sec. 1221(1)). The place-of-sale rule is not retained, however, in certain cases where a nonresident's sale of inventory is attributable to an office or other fixed place of business in the United States, as described below.

Income derived from the sale of depreciable personal property

Subject to a special rule, income derived from the sale of depreciable personal property, to the extent of prior depreciation deductions, is sourced under a recapture principle. Specifically, gain to the extent of prior depreciation deductions from the sale of depreciable personal property is sourced in the United States if the depreciation deductions giving rise to the gain were previously allocated against U.S. source income. If the deductions giving rise to the gain were previously allocated against foreign source income, gain from the sales (to the extent of prior deductions) is sourced foreign. Any gain in excess of prior depreciation deductions is sourced pursuant to the place of sale rule, as under prior law. These rules apply without regard to the residence of the taxpayer.

Depreciation deductions, as defined in the Act, mean any depreciation or amortization or any other deduction allowable under any provision of the Code which treats an otherwise capital expenditure as a deductible expense. Thus, for example, depreciation deductions include depreciation allowed for tangible property and amortization allowed for intangible property. Depreciable personal property means any personal property if the adjusted basis of the property includes depreciation adjustments. Depreciation adjustments are adjustments reflected in the adjusted basis of any property on account of depreciation deductions (whether allowed with respect to such property or other property and whether allowed to the taxpayer or to any other person). Income from the sale of intangible property that is attributable to the recapture of previously allowed amortization deductions was intended to be sourced pursuant to this recapture rule and not the residence-of-the-seller rule.[2] Income from such a sale in excess of previous amortization deductions, to the extent payments are not contingent on the productivity, use, or disposition of the intangible, is sourced under the residence-of-the-seller rule, as described above.

The Act provides a special rule for determining the source of recapture income from the sale of certain depreciable personal property. If personal property is used predominantly in the United

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[2] A technical correction may be necessary so that the statute reflects this intent.

States for any taxable year, the taxpayer must treat the allowable deductions for such year as being allocable entirely against U.S. source income. If personal property is used predominantly outside the United States for any taxable year, the taxpayer must treat the allowable deductions for such year as being allocable entirely against foreign source income. This special rule does not apply for certain personal property generally used outside the United States (personal property described in sec. 48(a)(2)(B)). Consequently, a segregation of allowable deductions between the sources of income the deductions previously offset is required for such property.

Income attributable to an office or other fixed place of business

The Act provides another exception to the residence rule for income derived from the sale of personal property when the sale is attributable to an office or other fixed place of business.

For U.S. residents, this office rule applies only if income is not already sourced as U.S. or foreign under the place-of-sale rule as retained under the Act (which applies to inventory property, gain in excess of recapture income for certain depreciable personal property, and stock of certain affiliates), or the recapture rule for depreciable personal property. Under this office rule, U.S. residents that derive income from sales of personal property attributable to an office or other fixed place of business maintained outside the United States generate foreign source income. However, the office rule only applies to U.S. residents, individual or otherwise, if an effective foreign income tax of 10 percent or more is paid to a foreign country on the income from the sale. For this purpose, an income tax is intended to be defined as it is under the general rules for determining creditable foreign taxes (secs. 901-908). Thus, for example, a "soak-up" tax of 10 percent would not qualify for this purpose. The 10-percent tax rule is designed to reflect Congress' general intent that the source of income for U.S. residents be the United States unless the income is subject to meaningful foreign tax. The office rule was intended to apply to income derived from the sale (for noncontingent payments) of intangible property by a U.S. resident if the income is attributable to a fixed place of business in a foreign country and the U.S. resident pays an income tax at an effective rate of 10 percent or more.[3]

United States citizens and resident aliens, even if not selling property attributable to a foreign office, can also generate foreign source income if the individual has a tax home in a foreign country. In either case, however, any income from a sale is not foreign source if the income is not subject to an effective foreign income tax of 10 percent or more.

For nonresidents, the Act applies the office rule to income derived from the sale of any personal property if the sale is attributable to a U.S. office or other fixed place of business. Thus, regardless of the place of sale, income derived from sales of personal property that are attributable to an office or other fixed place of business maintained in the United States by a nonresident is treated as U.S.

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[3] A technical correction may be needed so that the statute reflects this intent.

source. Pursuant to the Code's rules defining effectively connected income, this income generally will be treated as effectively connected and subject to U.S. tax.

Income derived by nonresidents from the sale of inventory property is not treated as U.S. source under the office rule, however, if the property is sold or exchanged for use, consumption, or disposition outside the United States, an office or other fixed place of business maintained outside the United States by the person materially participates in the sale, and the sale occurs outside the United States. In this case, the income is sourced by reference tc the place of sale.

In determining whether income is attributable to an office or other fixed place of business, the Act provides that the principles embodied in Code section 864(c)(5) apply. Thus, in general, the office of an independent agent is not attributed to a taxpayer, an office must be a material factor in the production of income, and income must be properly allocated to an office. Because prior law applied these principles only to foreign persons with U.S. offices and to a limited category of income items, these principles may have to be modified under regulations to properly take account of the Act's expansion of the office rule to U.S. residents who maintain a foreign office and to all income items. In addition, the prior law limit on the amount of income attributed to an office may have to be modified to reflect the repeal of the place-of-sale rule. For example, a sale of personal property which was primarily used in one jurisdiction is not generally to be attributed to an office in another jurisdiction.

Income derived from the sale of stock in foreign affiliates

A place-of-sale rule applies to income derived by U.S. corporations from the sale of stock in certain foreign corporations. If a U.S. corporation sells stock of a foreign affiliate in the foreign country in which the affiliate derived from the active conduct of a trade or business more than 50 percent of its gross income for the 3-year period ending with the close of the affiliate's taxable year immediately preceding the year during which the sale occurred, any gain from the sale is foreign source. An affiliate, for this purpose, is any foreign corporation whose stock is at least 80 percent owned (by both voting power and value).

Goodwill

Under the Act, payments in consideration for the sale of goodwill are treated as from sources in the country in which the goodwill was generated.

Other rules

The Act clarifies that any portion of the gain from the sale of stock in a controlled foreign corporation by a U.S. shareholder that is treated under section 1248(a) as a dividend is sourced pursuant to the source rules governing dividends (generally residence of the payor).

The Act provides that regulations are to be prescribed by the Secretary carrying out the purposes of the Act's source rule provisions, including the application of the provisions to losses from sales of personal property and to income derived from trading in futures contracts, forward contracts, options contracts, and similar instruments. It is anticipated that regulations will provide that losses from sales of personal property generally will be allocated consistently with the source of income that gains would generate but that variations of this principle may be necessary. Regulations may also be required to prevent persons from establishing partnerships or corporations, for example, to change their residence to take advantage of these rules. It may be appropriate to establish an anti-abuse rule to, for example, treat a foreign partnership as a U.S. resident to the extent its partners are U.S. persons.

The Act repeals section 871(e). Consequently, taxpayers no longer can treat all of the gain from the sale of certain intangible property as being from payments which are contingent on the productivity, use, or disposition of the property if more than 50 percent of the payments from the sale are so contingent. Instead, taxpayers are required to segregate the gain from the sale or exchange of certain intangible property into gain contingent on the productivity, use, or disposition of the property and gain which is not so contingent. Withholding is required only with respect to U.S. source payments that are contingent on the productivity, use or disposition of the property. As under prior law, gain to the extent of payments which are not contingent on the productivity, use, or disposition of the property is treated as gain from the sale of personal property.

Finally, the Act directs the Treasury Department to study the effect of the title passage rule as it applies in determining the source of income from the sale of inventory property. In the study, the Treasury Department is directed to take into account the Act's lower tax rates and Congressional trade concerns, and to report back to the House Committee on Ways and Means and the Senate Committee on Finance not later than September 30, 1987.

Effective Date

The provisions affecting foreign persons (other than controlled foreign corporations) are effective for transactions after March 18, 1986. The provisions affecting U.S. persons and controlled foreign corporations are effective in taxable years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by less than $5 million annually.

2. Special rules for transportation income (sec. 1212 of the Act and secs. 861, 863, 872, 883, and new sec. 887 of the Code)[4]

Prior Law

Overview

In general, the United States taxes the worldwide income of U.S. persons whether the income is derived from sources within or outside the United States. On the other hand, nonresident aliens and foreign corporations (even those which are owned by U.S. persons) generally are taxed by the United States only on income effectively connected with a U.S. trade or business (which is taxed on a net income basis) and on their other U.S. source income (which is taxed on a gross income basis). To eliminate double taxation, the United States permits certain foreign income taxes to offset U.S. tax imposed on foreign source income.

The U.S. tax laws contained a number of special rules which frequently resulted in income earned in transporting persons and cargo from one country to another, by both U.S. and foreign persons, being subject to very little U.S. tax. Some foreign countries tax U.S. persons on this kind of income, however.

Source rule for transportation income

Under the Tax Reform Act of 1984, all income attributable to transportation which begins and ends in the United States is treated as U.S. source income. Income attributable to transportation which begins in the United States and ends in a U.S. possession (or which begins in a U.S. possession and ends in the United States) generally is treated as 50-percent U.S. source income and 50-percent foreign source income. These provisions apply to both U.S. and foreign persons. For purposes of these provisions, transportation income is defined as any income derived from, or in connection with, the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. Thus, these source rules apply to income attributable to both rental income (*e.g.*, bareboat charter hire) and transportation services income (*e.g.*, time or voyage charter hire). Also, these rules apply to both companies earning transportation income and their employees, so that they apply to, for example, the wages of personnel on carriers. Transportation income includes income from transporting persons as well as income from transporting property. The term "vessel or aircraft" includes any container used in connection with a vessel or aircraft. Income derived from the lease of a container vessel is therefore transportation income under these rules.

For income earned in transporting persons and cargo from the United States to a foreign country, or between two foreign countries, source determination under prior law was dependent on the type of income produced. If the income was rental income (*e.g.*, bareboat charter hire), it was foreign source to the extent allocable to periods when the vessel (or aircraft) was outside the United States and its territorial waters (*i.e.*, outside the three-mile limit). If the income was from transportation services income (*e.g.*, time or voyage charter hire) the income was sourced under Treasury regulations. These regulations provided that taxable income or loss generally was allocated between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the territorial waters of the United States were treated as foreign for purposes of this calculation. Therefore, under prior law, most of the income earned in transporting persons and cargo from the United States to a foreign country, or between two foreign countries, whether it was rental or transportation services income, was foreign source.

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[4] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 613; H.Rep. 99-426, pp. 369-372 and 443-448; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 913; S.Rep. 99-313, pp. 336-344; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 596-599 (Conference Report).

A special rule provided that income derived from the lease or disposition of vessels and aircraft that were constructed in the United States and leased to U.S. persons was treated as wholly U.S. source income (Code sec. 861(e)). Expenses, losses, and deductions incurred in leasing the vessels and aircraft were allocated entirely against U.S. source income. These rules applied regardless of where the vessel or aircraft was used.

Another special rule applied to transportation income (as defined under the 1984 Act) and expenses associated with the lease of an aircraft (wherever constructed) to a regularly scheduled U.S. air carrier, to the extent the aircraft was used on routes between the United States and U.S. possessions (sec. 863(c)(2)(B)). This rule provided that the gross income of the lessor was U.S. source; the expenses associated with the gross income were allocated entirely against U.S. source income.

Foreign flag transportation

Foreign owned transportation entities were often exempted from U.S. tax on certain income by reciprocal exemption. Under the reciprocal exemption provisions, foreign owners were exempt from U.S. tax on income derived from the operation of a ship or aircraft documented or registered under the laws of a foreign country which granted an equivalent exemption to (or imposed no tax on) U.S. citizens and domestic corporations (secs. 872(b)(1) and (2) and 883(a)(1) and (2)). The determination that a foreign country granted an equivalent exemption was usually confirmed by an exchange of notes between the two countries. Reciprocal exemptions under these provisions were previously in effect with many foreign countries whose residents engaged in international transportation activities. The reciprocal exemption provisions applied independently with respect to shipping and aircraft income. Thus, while in most cases both types of income were covered by the exemptions, in some cases the exemptions covered one but not the other. As the exemptions applied only to income derived from the operation of vessels (or aircraft), the Internal Revenue Service held in Revenue Ruling 74-170, 1974-1 C.B. 175 that the exemptions did not apply to bareboat charter income.

In addition to the reciprocal exemption provided in the Code, the United States has approximately 35 income tax treaties providing for reciprocal exemption which exempt certain income from transporting persons and cargo from taxation by either country even if there is no statutory exemption. (Although there generally is substantial overlap, the typical treaty reciprocal exemption sometimes has a different scope from the statutory reciprocal exemption.) These treaties are in effect with virtually all of the developed countries.

Despite the numerous Code and treaty reciprocal exemptions that the United States had granted, there were several countries that had not entered into exemption agreements with the United States. Some of these countries impose a tax (generally a gross basis tax) on the transportation income of U.S. persons.

When a reciprocal exemption was not in force, the foreign tax burden on U.S. persons earning income from transporting persons or cargo generally was greater than the U.S. tax on persons from the other country who earned similar income from the United States. This occurred because, as noted above, the United States treated only a small amount of this income as U.S. source and attempted to tax this income on a net income basis; thus, the amount of U.S. source gross income generally could be eliminated by depreciation and other deductions allocable to the income. Foreign countries that tax this income, on the other hand, generally treat as local source the income attributable to either the entire inbound or entire outbound leg of the trip and often imposed tax on a gross income basis. The absence of meaningful U.S. tax when a reciprocal exemption was not in force consequently resulted in U.S. transportation companies being at a competitive disadvantage, vis-a-vis their foreign counterparts.

U.S.-controlled foreign flag transportation

Benefits from the Code and treaty reciprocal exemption provisions were derived not only by strictly foreign operators, but also by U.S. citizens and domestic corporations who operated their ships and aircraft through controlled foreign subsidiaries. A substantial percentage of U.S.-owned foreign ships were registered in one of three countries: Liberia, the United Kingdom, or Panama, each of which qualified for a reciprocal exemption.

Operators who incorporated outside their residence countries and who registered their ships or aircraft in a foreign country with no intention of operating the ships or aircraft in the domestic or foreign commerce of that foreign country were often referred to as using "flags of convenience". As a general rule, most flag of convenience shipping companies, including those registered in Liberia and Panama, were able to obtain the reciprocal exemption provided in the Code.

Reasons for Change

Source of income

Under prior law, a very small portion of income earned from transporting persons and cargo from the United States to a foreign country was U.S. source. Congress believed that the U.S. source portion of this income generally should be greater than the amount determined under prior law. Consistent with its general reevaluation of prior law's source rules, Congress generally did not believe that U.S. persons should be allowed to generate foreign source income (or loss) unless the income (or loss) is generated within a foreign country's tax jurisdiction and subject to foreign tax. Congress believed that the United States has the right to assert primary tax jurisdiction over income earned by its residents that is not within any other country's tax jurisdiction. (Prior law's treatment of this income as foreign source had the effect of relinquishing primary tax jurisdiction over a substantial amount of this income.)

The operation of prior law had two undesirable effects. First, for U.S. persons, income that did not have a nexus with any foreign country and was only partially, if at all, subject to foreign tax inappropriately increased the foreign tax credit limitation of the taxpayer. (Conversely, losses treated as foreign source reduced the taxpayer's foreign tax credit limitation despite the absence of a nexus with a foreign country.) A taxpayer with excess foreign tax credits from unrelated foreign operations then was allowed, by characterization of income as foreign rather than U.S. source, to offset all or part of any U.S. tax that otherwise would have been imposed on this income. Thus, a profitable taxpayer with excess foreign tax credits had a competitive advantage over a taxpayer who did not have excess foreign tax credits. Second, prior law's understatement of U.S. source income tended to subject foreign persons to too little U.S. tax. In Congress' view, prior law did not allow the United States to assert proper tax jurisdiction.

Congress also believed that the prior law provisions that allowed lessors to treat losses (or income) from the lease of an aircraft as wholly U.S. source income did not reflect economic reality. Congress believed that the income or loss should be sourced under the rules that apply to U.S. taxpayers generally.

Tax on transportation income

Congress recognized that expanding the source rule for income derived from transporting persons and cargo may subject foreign persons to a greater amount of U.S. tax. In Congress' view, a further change in the U.S. taxing rules was also necessary. Congress believed that a tax based on gross U.S. source income derived by foreign persons was the most practical way to collect U.S. tax on such income, unless the foreign person has a substantial and regular presence in the United States, more than that required under prior law. Congress further anticipated that increased U.S. taxation of persons from foreign countries that have not entered into reciprocal exemptions with the United States will encourage those countries to do so.

Reciprocal exemption

Under prior law, the reciprocal exemption provisions eliminated U.S. tax on foreign persons (even U.S.-controlled foreign corporations) by allowing exemptions based on country of documentation or registry, without regard to whether persons receiving the exemption resided in that country or whether commerce was conducted in that country. This placed U.S. persons with U.S.-based transportation operations and subject to U.S. tax at a competitive disadvantage vis-a-vis their foreign counterparts who claimed exemption from U.S. tax and who were not taxed in their countries of residence or in the countries where the ships were registered. In cases where residents of a country with which the United States might desire a reciprocal exemption used vessels or aircraft under another flag ("flagging out"), the unilateral U.S. concession provided by prior law left the other country little incentive to exempt U.S. shippers. Congress understood that the reciprocal exemption provisions were not enacted to provide worldwide exemption from income tax. Instead, in Congress' view, the reciprocal exemption provisions were enacted not only to promote international commerce by eliminating double taxation, but also to reserve the right to impose tax on income derived from transporting persons and cargo to the country of residence of the taxpayer. International practice, as reflected in tax treaties, is for the source country to provide reciprocal tax benefits to residents of the other contracting country.

The Act repeals the prior law exception to Subpart F (which allowed controlling U.S. shareholders of a foreign shipping corporation controlled by U.S. persons to avoid current U.S. tax on some of the corporation's income). Congress believed that it generally was appropriate to permit these corporations to claim exemption under the agreement between their country of incorporation and the United States, notwithstanding that they are not owned by residents of that country, as long as the corporations are organized in a country that does not tax U.S. residents. Congress further believed that a corporation whose stock is publicly traded primarily in the country of organization should be presumed to be owned by local residents. Thus, Congress believed that corporations owned in this manner should be exempt from the tax as long as the corporations are organized in a country that does not tax U.S. residents.

Finally, Congress believed that it was appropriate to extend the reciprocal exemption to types of transportation income not clearly encompassed under prior law. For example, Congress believed that it was appropriate that income from the bareboat charter of a ship or the lease of an aircraft be eligible for reciprocal exemption. In addition, Congress believed that it would generally be appropriate to treat different types of transportation income independently for reciprocal exemption purposes. Congress therefore provided the Secretary authority to exempt different types of transportation income on a reciprocal basis.

Explanation of Provision

Source of transportation income

The Act provides that 50 percent of all income attributable to transportation which begins or ends in the United States is U.S. source. The provision applies to both U.S. and foreign persons. The Act defines transportation income as under prior law. Therefore, the Act applies to income derived from, or in connection with, the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. The Act modifies prior law, however, by excluding from transportation income income from the performance of services by seamen or airline employees for transportation that begins or ends in the United States. Income from the performance of services attributable to transportation that begins and ends in the United States and of services attributable to transportation between the United States and a U.S. possession is still included in transportation income. Personal service income excluded from transportation income under the Act is sourced as under prior law: income attributable to services performed in the United States or within the U.S. territorial waters is U.S. source.

Income from the bareboat charter hire of vessels or aircraft is subject to the Act's provisions. Congress intended, however, that income derived from the lease of a vessel not used to transport cargo or persons for hire be characterized as ocean activity income and be sourced in the country of residence of the person earning the income, as prescribed in section 1213 of the Act, rather than as transportation income.

The Act also repeals the special rule relating to the lease or disposition of vessels, aircraft, or spacecraft which are constructed in the United States (former sec. 861(e)) and the special rule relating to the lease of an aircraft to a regularly scheduled U.S. air carrier (former sec. 863(c)(2)(B)). The source of this income, to the extent treated as transportation income, is determined under the general rule described above.

The source rules covered by the Act apply only to income attributable to transportation that begins or ends in the United States. Thus, if a voyage that begins in Europe has intermediate foreign stops before it arrives in the United States, 50 percent of the income that is attributable to the cargo (or persons) carried from its port of origin or from any of the intermediate ports to the United States is considered U.S. source. Cargo or passengers offloaded at intermediate ports before arrival in the United States will not give rise to U.S. source income.

Congress intended that income derived from furnishing round-trip travel originating in or ending in the United States be treated as income attributable to transportation that begins (for the outbound portion), or ends (for the inbound portion), in the United States under the Act's provision. Thus, 50 percent of the income attributable to the outbound transportation and 50 percent of the income attributable to the inbound transportation is U.S. source. For example, 50 percent of the income attributable to the first and last legs of round-trip travel by a cruise ship, originating in the United States, calling on foreign ports, and ending in the United States, is to be U.S. source. Similarly, 50 percent of the income attributable to both legs of an air voyage from the United States, to a foreign country, and back to the United States (or from a foreign country, to the United States, and back to a foreign country) is intended to be U.S. source.

Gross basis tax

The Act generally imposes a four percent tax on the gross U.S. source transportation income (as defined above) of foreign persons. The Code's 30 percent gross basis income withholding tax (under secs. 871 and 881) does not apply to any income subject to the four percent tax. Thus, bareboat charter income subject to the four percent tax is not also subject to 30 percent withholding.

If a foreign person is engaged in a trade or business in the United States and the foreign person's transportation income is effectively connected with the trade or business, the foreign person must, in lieu of paying the four percent gross basis tax, file a U.S. tax return and pay tax on its net effectively connected income. For a foreign person's transportation income (other than leasing income) to be effectively connected with the conduct of a U.S. trade or business under the Act, (1) the foreign person must provide regularly scheduled transportation into, out of, or within the United States; (2) substantially all of the person's U.S. source transportation income must be attributable to the regularly scheduled transportation; and (3) the foreign person must maintain a fixed place of business in the United States through which the foreign person conducts its U.S. transportation business. Thus, for example, an occasional flight or voyage to the U.S. will not allow foreign persons to treat themselves as being engaged in a U.S. trade or business and thereby avoid the gross basis tax. For a foreign person engaged in the leasing of ships or aircraft to derive effectively connected transportation income, the foreign person must maintain a fixed place of business in the United States and substantially all of the person's U.S. source gross transportation income must be attributable to the fixed place of business.

If a foreign person's transportation income is effectively connected with the conduct of a U.S. trade or business, this income, like other effectively connected income, is also subject to the Act's branch profits tax (as provided in sec. 1241). However, if a foreign person's income is exempt from tax because of a reciprocal exemption, the income is exempt from the branch profits tax.

The gross basis tax is to be collected by return. However, Congress was concerned that this method of collecting the tax would not yield adequate compliance. Congress therefore intended that the tax-writing committees of Congress study whether alternate, potentially more effective, methods of collecting the tax are feasible. Congress also intended that the Secretary monitor compliance with the Act's provisions and suggest to Congress alternative measures if return filing does not result in adequate compliance.

The gross basis tax is not intended to override U.S. income tax treaties with foreign countries. Therefore, a foreign person entitled to a treaty exemption is not subject to the tax. Also, the residence-based reciprocal exemption (described below) applies to gross income; thus, any such exemption will apply to the gross basis tax.

Reciprocal exemption

Under the Act, the prior law reciprocal exemption is modified to cover only foreign persons that are residents of a foreign country that reciprocally exempts U.S. residents and domestic corporations. The exemption is, therefore, no longer based on the place of registry or documentation.

The Act's reciprocal exemption extends to alien individuals who are residents of a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption. For a foreign corporation to qualify for the reciprocal exemption, the corporation must be organized in a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption. Congress intended that a country which, as a result of a treaty with the United States, exempts U.S. residents and domestic corporations from tax on income derived from the operation of ships or aircraft, qualify under the Act, even though the treaty technically contains certain additional requirements other than residence such as registration or documentation of the ship or aircraft.

Congress did not intend to deny any benefits available under an income tax treaty between the United States and a foreign country. For example, a treaty which extends reciprocal exemption to U.S. residents but not to all U.S. citizens, is not overridden. Congress did intend, however, that any treaties that do not contain residence-based exemptions be renegotiated by the Treasury Department to comply with the Act's provisions.

In determining whether a reciprocal exemption is residence-based, more than 50 percent of the ultimate individual owners of the foreign corporation must be residents of a foreign country that grants U.S. citizens and domestic corporations equivalent exemption (either by treaty or by residence-based reciprocal exemption). Thus, it is not enough for the foreign corporation to be organized in a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption: most of its owners must reside in such a country as well. Individuals that reside in countries which have residence-based reciprocal exemptions with the United States qualify for this purpose even if they are citizens or subjects of third countries that do not have qualifying exemptions in place. Congress intended that residence, for this purpose, mean the country of an individual's tax home, as defined in section 911(d)(3).

Ultimate individual ownership is determined under the Act by treating stock owned directly or indirectly by or for any entity (for example, a corporation, partnership, or trust) as being actually owned by the stockholder (or partner, grantor, or beneficiary, as the case may be) of that entity and by further attributing that ownership to its owners if necessary to reach individual owners.

The 50-percent ownership requirement does not apply if the foreign corporation is a controlled foreign corporation (as defined in sec. 957(a)). Thus, a controlled foreign corporation must only be organized in a foreign country which grants U.S. citizens and domestic corporations a reciprocal exemption in order for the corporation to be exempt from U.S. tax. The 50-percent ownership requirement also does not apply to any foreign corporation if the stock of the corporation is primarily and regularly traded on an established securities market in the foreign country in which the corporation is organized and that country provides a reciprocal exemption. For this purpose, "primarily" is intended to mean that more shares trade in the country of organization than in any other country. The publicly traded exception also covers a foreign corporation that is wholly owned by a second corporation organized in the same country as the first foreign corporation if the stock of the second foreign corporation is primarily and regularly traded on an established securities market in that country.

The Act expands the reciprocal exemption to income derived from the lease of vessels or aircraft as long as a foreign country exempts U.S. citizens and domestic corporations from its tax on comparable income. The Secretary is also provided authority to extend the reciprocal exemption to different types of transportation income on a case-by-case basis. For example, if the United States and a foreign country agree that only income from regularly scheduled transportation will be exempt from tax, then the Code's exemption can apply.

Effective Date

The provisions are generally effective for taxable years beginning after December 31, 1986. Leasing income will continue to be sourced under prior law for income attributable to an asset owned on January 1, 1986, if the asset was first leased before such date.

The Act extends the ownership requirement of the special leasing rule to January 1, 1987 for certain lessors.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $8 million in 1987, $16 million in 1988, $18 million in 1989, $25 million in 1990, and $30 million in 1991.

3. Source rule for space and certain ocean activities (sec. 1213 of the Act and sec. 863 of the Code)[5]

Prior Law

Activities conducted in space or outside the territorial waters of foreign countries take many forms: manufacturing occurs in space, spacecraft and satellites are leased, personal services are performed in space, and payments are made for other actual business operations conducted in space, such as research and development. Similarly, income from activities conducted outside the territorial waters of foreign countries takes many of the same forms: lease income, personal service income and business income.

The source of space and "high-seas" income depended under prior law on the type of activity performed. Lease income was generally sourced in the place of use; personal service income was generally sourced in the location in which the services were performed; and manufacturing and other business income was generally sourced where the activity took place. Therefore, because the equipment was generally used, the services generally performed, and the activities generally conducted outside the United States, the predominant part of income from space and high-seas activities was generally treated as foreign source income under prior law. This is because the United States considered within its primary tax jurisdiction only areas within the boundaries of its States and its territorial waters.

A special rule provided that certain income from leasing vessels, aircraft, or spacecraft was U.S. source (Code sec. 861(e)). This provision was applicable if the vessel, aircraft, or spacecraft was leased to U.S. persons, was eligible for the investment tax credit, and was manufactured or constructed in the United States. Because most tangible property used predominantly outside the United States was not eligible for the investment tax credit, the special rule had only limited application for spacecraft. Exceptions to the predominant use test existed for, among others, vessels documented under the laws of the United States, certain communications satellites, and certain property used in the Outer Continental Shelf or in certain international waters (sec. 48(a)(2)(B)).

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[5] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 615; H.Rep. 99-426, pp. 381-383; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 915; S.Rep. 99-313, pp. 357-360; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 599-600 (Conference Report).

Reasons for Change

The foreign tax credit rules are designed to prevent double taxation of income by the United States and foreign countries. The credit generally operates on the principle that the country in which income arises has the primary right to tax the income. In order to prevent the foreign tax credit from offsetting U.S. tax on U.S. source income, the credit is limited to the taxpayer's precredit tax on its foreign source income. In view of the purpose of the foreign tax credit, the source rules used in computing the foreign tax credit limitation are generally designed to identify as foreign source income that income which arises within a foreign country's jurisdiction and which might reasonably be subject to foreign tax.

Congress reevaluated prior law's policy in determining the source of various types of income (see, for example, sec. 1212 of the Act, regarding the source of transportation income). Congress concluded that asserting primary tax jurisdiction only over income generated within the United States and its territorial waters was inappropriate. In this regard, Congress enacted source rules the policy of which is to assert primary tax jurisdiction over income earned by U.S. residents that is not within any foreign country's taxing jurisdiction (i.e., a foreign country's boundaries and its territorial waters). In Congress' view, prior law treatment of this income as foreign source inappropriately allowed taxpayers with excess foreign tax credits to shelter this income from U.S. tax. Congress believed that the U.S. policy of the foreign tax credit will be better served by these new standards.

More specifically, Congress did not believe the prior rules governing the source of income were appropriate in their application to income derived from space or high-seas activities by U.S. residents. Congress noted that activities conducted in space and on or beneath the ocean had not been very prevalent. With this in mind, Congress believed that the Code's general source rules needed reexamination in their application to space and ocean activities. Moreover, when a U.S. taxpayer conducted activities in space or international waters, Congress noted that foreign countries had no apparent right to tax the income and generally did not tax the income. Thus, the foreign tax credit limitation was inflated by income that was not within any foreign country's tax jurisdiction such that a taxpayer with excess foreign tax credits from other operations could eliminate all tax (U.S. and foreign) on this income rather than eliminating double tax. Similarly, a taxpayer's foreign tax credit limitation might have been inappropriately reduced if the operations had been conducted at a loss.

Congress recognized, however, that international communications income had some potential to be taxed in a foreign country and believed that prior law's source rules applicable to U.S. persons with respect to this income warranted only partial modification. Congress also believed that prior law source rules may not have appropriately dealt with the U.S. taxation of international communications income derived by foreign persons. Congress noted that prior law potentially allowed foreign persons to maintain a U.S. office but to conduct their activities so as to generate nontaxable foreign source income through their U.S. offices.

Congress recognized that sourcing income derived from space and high-seas activities in the country of residence could have provided an unintended incentive for U.S. persons to conduct such activities through controlled foreign corporations. Congress believed, however, that since the Act included this income in the separate foreign tax credit limitation for shipping income (see Act sec. 1201) and subjected this income to current U.S. tax under the subpart F rules (see Act sec. 1221), its concerns that U.S. persons would conduct their space and ocean activities in a low-tax jurisdiction through the use of foreign corporations were generally abated. The separate foreign tax credit limitation generally provided Congress adequate assurance that high foreign taxes on unrelated income would not inappropriately offset U.S. taxes on this generally low-taxed income.

Explanation of Provision

The Act provides that all income derived from space or ocean activities is sourced in the country of residence of the person generating the income: income derived by United States persons (as defined in sec. 7701(a)(30)) is U.S. source income and income derived by persons other than U.S. persons is sourced outside the United States. Congress, however, provided the Secretary authority to prescribe anti-conduit provisions so as to treat certain foreign corporations controlled by U.S. persons as U.S. persons for purposes of these rules in certain circumstances.

Space or ocean activities as defined by the Act include any activities conducted in space, or on, in, or beneath water not within the jurisdiction (as recognized by the United States) of any country including the United States or its possessions. The term ocean activities also includes any activities performed in Antarctica. In defining space or ocean activities, Congress intended the term to include the following activities: the performance and provision of services in space or on or beneath the ocean, the leasing of equipment for use on or beneath the ocean (for purposes other than providing transportation) or in space (for example, spacecraft and satellites), the licensing of technology or other intangibles for use in space or on or beneath the ocean, and the manufacturing of property in space or on or beneath the ocean. The term ocean activities does not, however, include income derived from the operation or lease of a vessel if such vessel is used to transport cargo or persons for hire between ports-of-call.

The Act provides that regulations may describe other activities that may be considered space or ocean activities. For example, Congress intended that underwriting income from the insurance of risks on activities conducted in space or on or beneath the ocean be treated as derived from space or ocean activities.

Under the Act, space or ocean activities do not include any activity which gives rise to transportation income (as defined in sec. 863(c)) or any activity with respect to mines, oil and gas wells, or other natural deposits to the extent the mines or wells are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions. In the case of mines, oil and gas wells, or other natural deposits to the extent such mines or wells are not within the jurisdiction of the United States, U.S. possessions, or any foreign country, Congress intended the leasing of drilling rigs, the extraction of minerals, and the performance and provision of services related thereto to be ocean activities.

The Act also excludes from the definition of space or ocean activities international communications income, as defined. The Act provides that international communications income derived by U.S. persons is to be sourced 50 percent in the United States and 50 percent foreign if the income is attributable to communications between the United States and a foreign country. If the communication is between two points within the United States, the income attributable thereto is not international communications income and is to be entirely U.S. source. Congress intended the latter result even if the communication is routed through a satellite located in space, regardless of the satellite's location. If the communication is between the United States and an airborne plane or a vessel at sea outside the jurisdiction of any foreign country, Congress intended the communication to be treated as between two U.S. points and, thus, to be sourced in the United States. Finally, if the communication is between two foreign locations, Congress intended income attributable thereto to be entirely foreign source. Congress intended that international communication income include income attributable to any transmission between two countries of signals, images, sounds, or data transmitted in whole or in part by buried or underwater cable or by satellite. For example, the term includes income derived from the transmission of telephone calls.

When derived by foreign persons, the Act generally treats international communication income as foreign source. An exception to this general rule is provided if a foreign person maintains an office or other fixed place of business in the United States and the income is attributable to the U.S. office or other U.S. fixed place of business. This exception treats the income as entirely U.S. source. The Secretary is also given regulatory authority to treat other international communication income derived by a foreign person (e.g., a controlled foreign corporation) as other than foreign source. In particular, Congress anticipated that treatment of this income in the hands of controlled foreign corporations like similar income in the hands of U.S. persons would be necessary in certain circumstances to prevent manipulation of the provision.

As provided in section 1212 of the Act, Code section 861(e), treating certain income from the leasing of vessels or spacecraft as wholly U.S. source, is repealed.

Effective Date

The provision is effective for income earned in taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

4. Limitations on special treatment of 80/20 corporations (sec. 1214 of the Act and secs. 861, 871, 881, 1441, and 6049 of the Code)[6]

Prior Law

Under present and prior law, if U.S. source dividends and interest paid to foreign persons are not effectively connected with the conduct of a trade or business within the United States the withholding agent (which is generally the payor of such income) is generally required to withhold tax on the gross amount of such income at a rate of 30 percent (secs. 871(a) and 881(a)). The withholding rate of 30 percent may be reduced or eliminated by tax treaties between the United States and a foreign country. Furthermore, withholding is not required on certain items of U.S. source interest income. For instance, the Tax Reform Act of 1984 eliminated withholding on U.S. source portfolio interest. The United States does not impose any withholding tax on foreign source dividend and interest payments made to foreign persons, even if the payments are from U.S. persons.

Under present and prior law, dividend and interest income generally is sourced in the country of incorporation of the payor. However, under prior law, if a U.S. corporation earned more than 80 percent of its income from foreign sources for a three-year period (such a corporation was referred to as an "80/20 company"), then dividends and interest paid by that corporation generally were treated as foreign source income. Foreign countries generally do not tax dividends and interest paid by U.S. corporations to U.S. persons even though those dividends and interest may have been foreign source under prior law rules. The exception to the country-of-the-payor source rule also applied to resident alien individuals: if a resident alien received more than 80 percent of his or her income from foreign sources, interest paid by that individual was treated as foreign source.

Other exceptions to the country-of-incorporation source rules were designed as tax exemptions for limited classes of income earned by foreign persons. For instance, interest on foreign persons' U.S. bank accounts and deposits was exempt from U.S. withholding tax under prior law. The prior method of exempting this income was to treat it as foreign source.

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[6] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 612; H.Rep. 99-426, pp. 365-369; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 912; S.Rep. 99-313, pp. 333-336; H.Rep. 99-841, Vol. II (September 18, 1986), pp. 600-604 (Conference Report).

Reasons for Change

Congress was concerned that the prior rules for dividends and interest paid by 80/20 companies ceded primary tax jurisdiction away from the United States for income that should have borne U.S. tax. For example, foreign persons were able to arrange to have a U.S. holding company own the stock of a domestic operating subsidiary and the stock of a foreign operating subsidiary. If the income distributed by the foreign operating subsidiary to the holding company constituted at least 80 percent of the holding company's income such that the holding company was an 80/20 company, the ultimate foreign owners were able to shelter dividends and interest from the domestic operating subsidiary from U.S. withholding tax. If the foreign persons had owned the stock of the domestic operating subsidiary themselves, U.S. withholding tax would have been imposed. Congress believed that the United States should collect tax on the portion of dividends and interest paid to foreign persons that is attributable to U.S. source income of the payor. Moreover, in those cases where the U.S. corporation is not directly or indirectly conducting an active foreign business, Congress believed that the United States should not cede primary tax jurisdiction on any of the dividend or interest payments by that U.S. corporation.

Similarly, the prior treatment of dividends and interest paid by 80/20 companies had the result of artificially inflating U.S. persons' foreign source income for foreign tax credit limitation purposes. Congress was of the view that the United States should generally retain primary tax jurisdiction over dividends and interest paid by its residents. Congress did not believe that dividends paid by 80/20 companies to U.S. persons should be foreign source since the payor computed its foreign tax credit limitation, accounted for its foreign source income, and credited any foreign income taxes imposed on that income at the payor level. Under prior law, the full amount of the dividends (after reduction for any dividends received deduction) received by U.S. shareholders from 80/20 companies was treated as foreign source income, thereby increasing the foreign tax credit limitation of the U.S. shareholders. This was true even though up to 20 percent of the earnings from which the dividends were derived may have been from U.S. sources, and even though no foreign income taxes were likely to have been imposed on those dividends. Excess foreign tax credits from other operations could then shelter from U.S. tax at the shareholder level some or all of the dividends received from the 80/20 company (to the extent those dividends were not already sheltered by the dividends received deduction in the case of corporate shareholders).

With respect to interest payments made by an 80/20 company to U.S. persons, Congress thought it was appropriate to treat interest paid in connection with an active foreign business more favorably than dividends because that interest, unlike the dividends, was likely to reduce foreign income taxes that the 80/20 company had to pay and that the United States may have had to allow as a foreign tax credit. In these circumstances, however, Congress believed that income earned by an 80/20 company should retain its source when interest was paid to related persons so that the United States could collect U.S. tax when the interest was attributable to U.S. source income of the payor.

In adopting the new 80/20 standards, Congress decided against requiring a minimum amount of dividends and interest paid to foreign persons to be subject to U.S. tax because of the Act's minimum tax provision which ensures that profitable U.S. 80/20 corporations pay some U.S. tax (the provision that allows creditable foreign taxes to offset only 90 percent of the alternative minimum tax). Congress was of the view that that provision achieved its policy objective: that profits flowing though U.S. corporations not escape all U.S. tax at the corporate and shareholder levels.

Congress also believed the prior 80/20 rule was generally inappropriate in the case of individuals. If an individual received any U.S. income, U.S. tax should not be foregone upon interest payments to foreign persons merely because the individual also earned substantial foreign source income.

Furthermore, Congress believed that where it was desirable to provide a U.S. tax exemption for specific classes of income, it should generally be done directly rather than through modifications to the source rules. Congress, therefore, granted overt exemptions for appropriate classes of income earned by foreign persons in lieu of the de facto exemptions provided under prior law through the source rules.

Explanation of Provision

The Act repeals prior law as it applied to dividends paid by an 80/20 company (other than dividends paid by a possessions corporation) and treats dividends paid by U.S. corporations as U.S. source. When dividends paid by U.S. corporations are received by foreign persons, however, the Act provides a look-through rule in allowing an exemption from U.S. withholding tax by basing the amount of exemption on the source of the income earned by the 80/20 company when the 80/20 company satisfies an active foreign business requirement (discussed below). With respect to interest payments by an 80/20 company, the Act generally treats the interest as U.S. source unless the 80/20 company satisfies the active foreign business requirement (discussed below). If the active foreign business requirement is met, the Act treats interest paid by an 80/20 company as foreign source if the interest is paid to unrelated parties and as having a prorated source based on the source of the income of the 80/20 company if the interest is paid to related parties.

The active foreign business requirement is satisfied if at least 80 percent of the U.S. corporation's gross income for the 3-year period preceding the year of the payment is derived from foreign sources and is attributable to the active conduct of a trade or business in one or more foreign jurisdictions (or U.S. possessions). If this requirement is satisfied, dividends paid by a U.S. corporation to foreign shareholders of the U.S. corporation, though treated as U.S. source, are subject to U.S. withholding tax only on the fraction of the dividends paid by that corporation that the corporation's U.S. source gross income bears to the corporation's total gross income measured over the 3-year period preceding the year of payment. Interest received from a U.S. corporation that meets the above-described 80-percent active foreign business requirement is foreign source (and therefore exempt from U.S. withholding tax in the case of foreign recipients), as follows: unrelated recipients (U.S. or foreign) treat the entire interest payment as foreign source; related recipients treat as U.S. source a percentage of the interest equal to the ratio of the corporation's U.S. source gross income to the corporation's total gross income (measured over the 3-year period preceding the year of payment). The Act provides similar rules for interest paid by resident alien individuals engaged in active foreign businesses in one or more foreign jurisdictions.

The Act provides that the 80-percent active foreign business requirement may be met by the U.S. corporation alone or, instead, may be met by a group including domestic or foreign subsidiaries in which the U.S. corporation owns a controlling interest (Congress intended that at least a 50-percent ownership interest be required for a subsidiary's business to be attributed to a U.S. shareholder). In allowing attribution of a subsidiary's active foreign business to a controlling corporate shareholder, Congress intended that the character (i.e., active foreign business income) of the subsidiary's gross income be attributed to the corporate shareholder only on the actual receipt of income from the subsidiary, for example, dividends, interest, rents, or royalties, for the purpose of determining the percentage of dividends paid by the shareholder that are subject to U.S. withholding tax. Thus, for example, dividends received by a corporate shareholder from controlled U.S. subsidiaries, though treated as U.S. source by the Act, are to be characterized as active foreign business income for the purpose of this look-through rule in the same proportion that the controlled subsidiaries' active foreign business income bears to their total gross income. With respect to other items of income received from controlled subsidiaries, those amounts shall be characterized as active foreign business income to the extent they are allocated against active foreign business income of the payor (*i.e.,* this characterization follows the prinicples of the look-through rules of the foreign tax credit, new Code sec. 904(d)(3)(C)).

The Act's provisions can be illustrated by the following example. Assume that a U.S. corporation and an unrelated foreign corporation jointly incorporate a second U.S. corporation to operate a mining business in a foreign country. The second U.S. corporation earns $450 of income, all of which is foreign source, from the mining operation in its first year and $50 of U.S. source income from investments in the United States. At the end of the year, the second corporation distributes a $100 dividend to each of its two shareholders. The first U.S. corporation in turn distributes $50 to its shareholders, all of whom are foreign residents. The Act treats the $100 dividend to the first U.S. corporation as entirely U.S. source; the $100 dividend to the foreign shareholder is treated as U.S. source but 90 percent of the dividend is exempted from U.S. withholding tax. Since the first U.S. corporation owns a 50 percent interest in the second U.S. corporation and the first U.S. corporation received a dividend from the second U.S. corporation, the second U.S. corporation's active foreign business is attributed to the first U.S. corporation; therefore, assuming that the first U.S. corporation has no other income, the first U.S. corporation satisfies the 80-percent active foreign business requirement. Even though it is treated as U.S. source, the dividend from the second U.S. corporation retains the same character as the second U.S. corporation's income in determining the amount of dividends paid by the first U.S. corporation that is subject to U.S. withholding tax. Accordingly, since the first U.S. corporation has no other income, 90 percent of the first U.S. corporation's dividends paid to its shareholders are exempt from U.S. withholding tax and 10 percent are subject to U.S. withholding tax. If, however, for example, the first U.S. corporation had $13 or more of income that is not active foreign business income in that year, the first U.S. corporation would not satisfy the 80-percent active foreign business requirement and all of its dividends would, therefore, be subject to U.S. withholding tax. The fact that the first U.S. corporation is able to claim an 80-percent dividends received deduction on the dividend received from the second U.S. corporation is of no relevance in determining whether the first U.S. corporation satisfies the active foreign business requirement.

In determining whether interest recipients are related persons (for purposes of looking through to the amount of U.S. source income of the payor), the Act defines a related person as any individual, corporation, partnership, trust, or estate which owns a 10-percent interest in the payor, or in which the payor owns a 10-percent interest, as well as any person who holds a 10-percent interest in a corporation, partnership, trust, or estate which is owned by the same persons that own a 10-percent interest in the payor.

The Act's source rules apply before the application of the resourcing rules enacted in the Tax Reform Act of 1984. If a greater amount is treated as U.S. source under those provisions, however, such amount is to be treated as U.S. source (but only for foreign tax credit limitation purposes).

Prior law effectively exempted certain income paid by U.S. persons to foreign persons from U.S. withholding tax by treating the income as foreign source income. Under the Act, the income is treated as U.S. source, but the exemption from U.S. withholding tax is made explicit. The interest affected includes interest on deposits with persons carrying on the banking business, interest on deposits or withdrawable accounts with a Federal or State chartered savings institution as long as such interest is a deductible expense to the savings institution under section 591, and interest on amounts held by an insurance company under an agreement to pay interest thereon, but, in each case, only if such interest is not effectively connected with the conduct of a trade or business within the United States by the recipient of the interest. The Act also makes an explicit exemption from U.S. withholding tax for income derived by a foreign central bank of issue from bankers' acceptances. By treating the interest on deposits as U.S. source, Congress did not intend that the principal amounts which generate the income be includible in a foreign person's estate.[7]

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[7] A technical correction may be needed so that the statute reflects this intent.

Effective Date

The provision is generally effective for dividends and interest paid in taxable years beginning after December 31, 1986.

The provision is not effective for interest paid on debt obligations held on December 31, 1985, unless the interest is paid pursuant to an extension or renewal of that obligation agreed to after December 31, 1985. In the case of interest paid to a related person that benefits from this grandfather rule, the payments are treated as payments from a controlled foreign corporation for foreign tax credit purposes. As such, they retain their character and source.

In addition, the Act provides a transition rule for all 80/20 companies. Under this rule, in determining the amount of dividends paid to foreign shareholders and interest paid to related persons in 1987 that is subject to U.S withholding tax, a calendar year company which would have been an 80/20 company under prior law (using the base period 1984, 1985, and 1986) may use the prior law rules in computing the portion of dividends paid to foreign shareholders in 1987 which is subject to U.S. withholding tax and the portion of interest paid to related payees in 1987 which is U.S. source and subject to U.S. withholding tax. Interest paid to unrelated persons in 1987 is foreign source if paid by a corporation that is an 80/20 company under prior law. The Act provides that, for 1988 and subsequent years, the amounts of dividends and interest that are U.S. source and subject to U.S. withholding tax under the Act are determined by the payor's income measured over a base period beginning in 1987. Similar rules apply to 80/20 individuals (as defined under prior law).

For dividends paid by a certain 80/20 company, the provision is not effective until January 1, 1991, for dividends paid on stock outstanding on May 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

5. Allocation of interest and other expenses to foreign source income (sec. 1215 of the Act and sec. 864 of the Code)[8]

Prior Law

Under present and prior law, the Code provides, in general terms, that taxpayers, in computing taxable U.S. source and taxable foreign source income, are to deduct from U.S. and foreign source gross income the expenses, losses, and other deductions properly apportionable or allocable thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

Treasury regulation section 1.861-8 sets forth detailed allocation and apportionment rules for certain types of deductions, including those for interest expense and research and development expenditures. These regulations, insofar as they governed interest expense, generally were based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer regardless of any specific purpose for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Often, creditors of a taxpayer subject money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.

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[8] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 614; H.Rep. 99-426, pp. 372-381; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 914; S.Rep. 99-313, pp. 344-356; Senate floor amendments, 132 Cong. Rec. S7464 (June 13, 1986), and S7795 (June 18, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 604-607 (Conference Report).

In general, the regulation allowed taxpayers to choose between two methods of apportioning interest expense: an asset method and a gross income method. The regulation was based on the theory that normally the deduction for interest expense relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore that the deduction for interest should normally be apportioned on the basis of asset values. Indebtedness permits the taxpayer to acquire or retain different kinds of assets which may produce substantially different yields of gross income in relation to their value. According to the theory of the regulation, apportionment of an interest deduction on such basis as gross income may not be reasonable. (Treas. Reg. sec. 1.861-8(e)(2)(v)). Therefore, the asset method was the preferred method.

Under the asset method, taxpayers generally may choose between two methods of evaluating assets, the tax book value method and the fair market value method. The tax book value method considers original cost for tax purposes less depreciation allowed for tax purposes. The fair market value method considers fair market value of assets, but it is available only if the taxpayer can show fair market value to the satisfaction of the Commissioner. Taxpayers who use the fair market value method may not switch to the tax book value method without the Commissioner's consent.

If any taxpayer that was a member of an affiliated group that filed a consolidated return used the gross income method, then all members of the group had to use the same method. Under the gross income method, taxpayers generally apportioned the deduction on the basis of U.S. and foreign gross income. (Treas. Reg. sec. 1.861-8(e)(2)(vi)). The apportionment against foreign source income (or against U.S. source income) could not be less than 50 percent of what the apportionment would have been if the taxpayer used the asset method.

Despite the general adoption of the approach that money is fungible, the regulation governing interest expense deductions provides a limited exception that allows taxpayers to trace interest expense to certain assets without treating that interest expense as fungible (Treas. Reg. sec. 1.861-8(e)(2)(iv)). That exception applies to a limited class of nonrecourse debt.

Under the regulation, interest expense incurred by an affiliated group of corporations that filed a consolidated tax return was required to be apportioned between U.S. and foreign income on a separate company basis rather than on a consolidated group basis. This separate company apportionment rule conflicted with a Court of Claims case, *International Telephone & Telegraph Corp.* v. *United States* (79-2 USTC para. 9649), decided under the law in effect prior to the effective date of the Treasury regulation. The *ITT* case indicated that expenses that were not definitely allocable against U.S. or foreign gross income should be apportioned to gross income of a consolidated group on a consolidated group basis. It appeared that the *ITT* case had no effect in years to which the regulations applied.

The regulation generally allowed tax-exempt income and assets generating tax-exempt income to be taken into account in apportioning deductible expense. Banks and other financial institutions, which may deduct some interest used to carry tax-exempt assets, were the main beneficiaries of this rule.

Taxpayers generally allocated and apportioned expenses other than interest expenses on a company-by-company basis.

Reasons for Change

Allocation and apportionment generally

Congress recognized that proper rules governing the allocation and apportionment of expenses are essential to the proper functioning of the foreign tax credit limitation. Congress had addressed the expense side of the source question only in general terms, and had delegated to regulations the task of formulating rules governing expense allocation. Congress believed that these regulations had been manipulated by taxpayers, in some cases, to overstate foreign income. In other cases, the rules provided traps for the unwary.

Congress believed that it was important to reduce marginal U.S. tax rates. Congress was particularly concerned that with the lower U.S. rates the Act provides, taxpayers would have more excess foreign tax credits and more of an incentive to characterize their income as foreign source income. In this context, it was especially important to arrive at proper expense allocation rules.

In general, Congress did not believe that the approach of the prior regulations relating to the allocation of expense necessarily reflected economic reality. Congress believed that consideration of the entire affiliated group of taxpayers is more likely to yield an appropriate determination of how expenses relate to U.S. and foreign source gross income than the consideration of each separate taxpayer. In the case of an affiliated group of corporations joining in the filing of a consolidated return, Congress believed that consideration of group expenses can be accomplished with appropriate modifications of the separate company system of current law.

Congress concluded that it is similarly appropriate to consider the entire group when taxpayers are eligible to be included in a consolidated return but do not file one. Congress did not want to allow the use of deconsolidation (or failure ever to consolidate, in the case of new ventures) to defeat the more appropriate expense rules that it developed for consolidated groups. In this regard, Congress believed that these affiliated groups of corporations are sufficiently economically interrelated that the imposition of this requirement will provide a more accurate measurement of their economic income than did the allocation of deductions on a separate company basis. Congress did not believe that imposition of this requirement on nonconsolidated filers who are eligible to consolidate would prove onerous. Instead, Congress anticipated that an affiliated group rule would keep taxpayers from seeking to avoid the rules governing consolidated groups.

Congress believed it inappropriate to consider assets that generate tax-exempt income in allocating and apportioning expenses, because it is immaterial whether exempt income is U.S. source or foreign source. The inclusion of exempt U.S. source income and assets in the expense allocation increased the amount of expense allocated to U.S. source income even though the income generated was not subject to U.S. tax.

Interest expense

With limited exceptions, Congress believed it appropriate for taxpayers to allocate and apportion interest expense on the basis that money is fungible. In this respect, Congress adopted the theory of the Treasury Regulation governing the allocation of interest expense (see Treas. Reg. sec. 1.861-8(e)(2)(i)). However, Congress believed it inappropriate to apply the fungibility concept on the strict separate company basis of prior law when a taxpayer is a member of an affiliated group and is included in a consolidated return or is eligible to be included in a consolidated return. The strict separate company method of allocation enabled taxpayers to limit artificially the interest expense allocated to foreign source income by adjusting the location of borrowing within the affiliated group. This sometimes resulted in an unwarranted increase in the amount of foreign tax credits available to an affiliated group of corporations. In effect, prior law allowed taxpayers to arrange to have interest expense reduce U.S. income, even though that interest expense funded foreign activities (or freed up other cash to fund foreign activities), the income from which was sheltered from U.S. tax by the foreign tax credit or by the deferral of U.S. tax on the income of U.S.-owned foreign corporations. Thus, not only was no U.S. tax paid on the foreign investment, but the investment generated negative U.S. tax on U.S. income. That is, prior law allowed affiliated corporations to reduce U.S. tax on U.S. income by borrowing money through one corporation rather than another.

The following examples illustrate the tax planning possibilities under prior law.

Example 1

Assume that a U.S. corporation had $100 of U.S. assets and $100 of foreign assets, $20 of gross U.S income and $20 of gross foreign income. It incurred $20 of interest expense. Its net income was $20 ($40-$20). The interest expense reduced gross U.S. income and gross foreign income equally, resulting in $10 of each. Congress believed that the result of this example was appropriate.

Example 2

Under the Treasury regulations in effect under prior law, however, if all the taxpayer's assets generated gross U.S. income, then all the taxpayer's interest expense reduced gross U.S. income. To avoid having interest expense reduce foreign income, taxpayers could isolate interest expense in a corporation whose assets produced only U.S. income. This rule created opportunities for tax avoidance, as shown in the following example.

The facts are the same as Example 1, above, except that the U.S. parent corporation initially borrowed cash and contributed the cash to the capital of a U.S. subsidiary corporation (the sole asset of the U.S. parent) which then invested in foreign and domestic assets. These two corporations filed a consolidated return. The U.S. subsidiary had $100 of U.S. assets and $100 of foreign assets, $20 of gross U.S. income and $20 of gross foreign income. It incurred no interest expense. It paid all its $40 of earnings to the parent as a dividend. Under the consolidated return regulations, the parent had no income from this dividend, but it had $20 of interest expense. This $20 reduced only U.S. income.[9] The group had $20 of net foreign income (the interest expense did not reduce foreign income) and no net U.S. income. If foreign tax credits sheltered all the foreign income, the U.S. corporation could eliminate its U.S. tax on U.S. income, and consequently owe no U.S. tax at all.

Example 3

In addition, as shown in the following example, the rules requiring allocation on a separate company basis could furnish a trap for the unwary.

U.S. corporation 1 owned $100 of U.S. business assets and U.S. corporation 2 owned $100 of assets that it used in a foreign business. These corporations filed a consolidated return. U.S. corporation 2 incurred $20 of interest expense, while corporation 1 incurred no interest expense. Under the regulations, this $20 would have reduced only foreign gross income.

Despite Congress's general adoption of the approach that money is fungible, it believed that a limited exception, like that embodied in Treas. Reg. sec. 1.861-8(e)(2)(iv), that allows taxpayers to trace interest expense on certain nonrecourse debt to related assets will continue to be warranted. Moreover, Congress believed that it was appropriate for the Secretary to identify in regulations other circumstances where taxpayers can trace interest expense or debt incurred to acquire assets in certain integrated financial transactions.

Elimination of optional gross income method for allocating interest

Congress believed that the asset method more closely reflects economic reality than the gross income method. In this respect, Congress adopted the theory of the Treasury Regulations concerning the general preferability of the asset method (see Treas. Reg. sec. 1.861-8(e)(2)(v)).

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[9] The subsidiary was a U.S. asset in the hands of the parent under prior law as long as less than 80 percent of its gross income from the prior three years was foreign source.

The gross income method produced distortions under prior law. For example, when taxpayers conducted their foreign operations through foreign subsidiaries, they allocated interest expense against only the net dividend they received from the foreign subsidiary, not against the gross income that generated the net income that gave rise to the dividend. That rule tended to understate the allocation against foreign income and thus to overstate the allocation against U.S. income. That rule thus tended inappropriately to increase the foreign taxes that U.S. taxpayers could credit.

Improvement of asset method

Under prior law, taxpayers owning corporate stock and using the asset method generally treated their basis in corporate stock as the amount to which they apportioned expense. This stock basis amount did not reflect earnings and profits. This failure to consider earnings and profits caused significant distortion. Although the earnings were presumably reflected in the fair market value of the stock investments of those taxpayers using the fair market value method of apportionment, this was not the case for taxpayers using the tax book value method. Accordingly, for taxpayers using the tax book value method, the Act requires that the asset method consider earnings and profits of 10-percent or greater owned foreign and domestic corporations not included in the affiliated group for interest allocation purposes. This adjustment takes account of some changes in value attributable to taxpayers' equity interests in such corporations. Similarly, in the case of members of the affiliated group, the Act's look-through treatment considers the value of each member's assets (after proper exclusion of equity interests in other members) rather than only the basis of an upper-tier member's stock investments.

Congress did not believe that a general statutory requirement of annual valuation of assets was practical or administrable. Nonetheless, when taxpayers are willing and able to make annual valuations, Congress believed that an asset method based on fair market value is appropriate, so long as taxpayers cannot switch from the fair market value method to the tax book value method without approval from the Commissioner.

Expenses other than interest

While Congress believed that expenses directly allocable to an income-producing activity should directly reduce income from that activity, Congress concluded that, in the case of affiliated corporations, problems similar to those with the allocation of interest expense arose with other non-directly allocable expenses. Thus, Congress decided that the Act's general rule requiring an affiliated group to be treated as if it were one taxpayer was appropriate for expenses other than interest. For example, a U.S. parent holding corporation whose sole asset is 100 percent of the stock of a U.S. company that owns U.S. and foreign assets may incur general and administrative expenses. Congress did not believe that, in such a case, it is necessarily appropriate to deduct all such expenses from U.S. source income. Instead, within the context of the separate company system of prior law, it is appropriate to adopt a "look-through" approach for purposes of apportioning expenses incurred by the owner of such stock that are properly allocable to the class of income that includes dividends from such stock, whether or not paid, so long as this approach yields the same results that would obtain under a one-taxpayer approach.

Explanation of Provisions

Overview

The Act adds new Code section 864(e), which generally adopts a one-taxpayer rule and other rules for expense allocation for purposes of Subchapter N of the Code, sections 861 through 999, which generally provides rules for income arising outside the United States and for foreign taxpayers. The Act provides regulatory authority to remove provisions of Subchapter N from the scope of the rules of new Code section 864(e) where application of these rules would not be appropriate.

Interest expenses

Generally, money is to be treated as fungible, and interest expenses are to be prorated on the asset method. The Act does not change the treatment of non-recourse debt that the current regulation treats as definitely related to specific property (Treas. Reg. sec. 1.861-8(e)(2)(iv)). Congress did not intend to preclude the Secretary from treating other debt, including recourse debt, as definitely related to specific property to the extent necessary to preserve the principles of this legislation.

The Act provides, in general, that the taxable income of an affiliated group is to be determined by allocating and apportioning all interest expenses as if all members of the group were a single corporation.[10] In effect, taxpayers will disregard stock of affiliates and interaffiliate debt in allocating interest expenses. As a result, unless regulations provide for appropriate direct allocation of interest expense, the Act causes the amount of foreign source and U.S. source income on the consolidated return in each of the three numbered examples in the Reasons for Change section (where U.S. and foreign gross income are equal) to be the same: because U.S. and foreign assets are equal in each example, after allocation of interest expense, the $20 of net income in each example would consist of $10 of foreign source income and $10 of U.S. source income. Congress intended that taxpayers not be able to reduce artificially allocation of interest expense to foreign source income through intercompany lending and directed therefore that regulations provide for appropriate treatment in the case of interest payments among members of an affiliated group.

The Act specifies that taxpayers are to allocate and apportion interest expense on the basis of assets rather than gross income. That is, the Act no longer allows taxpayers to use the optional gross income method of the current regulation (or any similar method) for allocating and apportioning interest.

Congress did not intend that labels control whether expenses are interest expenses for this purpose; instead, Congress intended that economic reality govern. Thus, Congress intended that amounts denominated as interest but that are not interest as an economic matter not be treated as interest for this purpose. In particular, Congress recognized that deductions of life insurance companies described in section 807(c) (1), (2), (3), and (6) should not be treated as interest expenses for this purpose.

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[10] Congress did not intend, however, that new Code section 864(e)(1) apply for purposes of computations under section 936(h) (relating to the possessions tax credit).

The Act contains an exception to the rule requiring an affiliated group to be treated as if all members of the group were one taxpayer for purposes of allocating and apportioning interest expense. That general rule does not apply to any financial institution (described in section 581 or 591) if the business of the financial institution is predominantly with persons other than related persons or their customers, and if the financial institution is required by State or Federal law to be operated separately from any other entity which is not a financial institution. If this exception applies, the financial institution is not treated as a member of the group for applying the Act's general one taxpayer rule to other members of the group; instead, all banks in a group are to be treated as one taxpayer (rather than each bank being treated as a separate taxpayer for this purpose). The other members of the group are still treated as one taxpayer for interest expense allocation purposes. The financial institution is still part of the group that the Act treats as one taxpayer for expenses other than interest.

In the case of an integrated financial transaction such as a debt-financed acquisition of foreign currency debt obligations or similar arbitrage transactions, the Act authorizes the Secretary to provide for the direct allocation of interest expense incurred on funds borrowed to acquire these assets against income from the assets involved in the integrated transaction, if appropriate. In addition, Congress intended that the Secretary use the regulatory authority provided in the agreement to allocate interest expenses directly to interest or other passive income where such a direct allocation is necessary to prevent taxpayers from defeating the purposes of this provision.

Expenses other than interest

In the case of expenses other than interest that are not directly allocable to specific income producing activities, the bill effectively treats the U.S. affiliated group as one taxpayer. That is, taxpayers are, in effect, to disregard stock of affiliates and interaffiliate debt. Congress believed that this intended result may be achieved under regulations that, for example, retain the separate company method of allocation of prior law but that, unlike prior law, treat stock in domestic subsidiary corporations as a foreign asset to the extent the domestic corporation (or its subsidiaries on a "look-through" basis) owns assets that produce foreign source income. Treating a U.S. group as if it were one taxpayer for expenses that are not directly allocable, however, does not change the prior law rules governing whether expenses are directly allocable. As under prior law, expenses that a corporation at the lowest corporate tier (one with no subsidiaries) incurs only to earn its own income (and not to help affiliates earn income) are allocated to its income only for purposes of these rules.

When a corporation owns stock in subsidiaries, it may incur some expenses that are allocable to specific income producing activities. For instance, a corporation that owns stock in subsidiaries may also conduct direct operations on its own behalf. Expenses other than interest incurred to conduct those operations are allocable, as under prior law, to the income from those operations. If a corporation incurs expenses that are not directly allocable to specific income producing activities, the Act generally requires the allocation of those expenses under the one-taxpayer principles that apply to interest expenses. The Act does not treat such expenses as fungible. The Act requires instead that expenses not allocable to specific income producing activities be allocated or apportioned without regard to holding companies, corporate layers, or artificial structures. For example, the salary of the president of a U.S. corporation that only owns a U.S. holding company that holds both U.S. and foreign subsidiaries will be allocated (if appropriate) between U.S. and foreign source income as if the U.S. corporations were all one corporation. (*See, e.g.*, Treas. Reg. sec. 1.861-8(b)(3) and (e)(4).)

Similarly, the Act generally does not change the treatment of items such as labor costs or costs of materials, which, to the extent that they are elements of cost of goods sold, are generally not subject to allocation or apportionment.

Rules applicable to all expenses

The Act provides that tax-exempt assets and income associated therewith are not to be taken into account in allocating or apportioning any deductible expense. This rule applies to all expenses including interest. For this purpose, a similar rule applies to the extent that dividends (other than dividends qualifying under section 243(b) for the 100-percent dividends received deduction) are eligible for the dividends received deduction under section 243 or section 245(a), and with respect to any stock yielding such dividends (again, not including "qualifying dividends" under section 243(b)). Thus, 80 percent of stock that pays dividends that are eligible for the 80-percent dividends received deduction is treated as a tax-exempt asset.

Congress understood that other Code provisions disallow deductions for expenses in certain cases. For instance, expenses incurred to carry tax-exempt assets are sometimes disallowed (*see, e.g.* sec. 265). Expenses disallowed under such rules are not allocated under this provision.

Congress intended that interest expenses incurred on debt obligations that are used to finance portfolio stock (Code sec. 246A) be directly allocated to the increase in income arising from the disallowance of the dividends received deduction. A similar rule is intended to apply to life insurance companies, which are to treat deductions for an amount of reserve and other deductions, rather than the deduction for dividends received, as being reduced.

For the purpose of expense allocation, the Act includes within the affiliated group whose expenses and assets go into the allocation determination not only members of the U.S. consolidated group (or corporations eligible to consolidate), but also section 936 companies (possessions corporations) that would be eligible to consolidate absent statutory prohibition.

When the tax book value method of apportionment is used, the Act provides a new rule to allocate and apportion expenses on the basis of assets when the asset is stock in one of certain corporations. If a 10-percent or more owned corporation is not included in the group treated as one taxpayer, then, in general, the adjusted basis of the stock owned in such corporation in the hands of a U.S. shareholder is increased by the amount of the earnings and profits of the corporation attributable to that stock and accumulated during the period the taxpayer held it. Earnings and profits are not limited to those accumulated in post-enactment years. (In general, two kinds of 10-percent owned corporations are not included in the one-taxpayer group: foreign corporations, and U.S. corporations that are more than 10- but less than 80-percent owned.) In the case of a deficit in earnings and profits of the corporation that arose during the period when the U.S. shareholder held the stock, that deficit reduces the adjusted basis of the asset in the hands of the shareholder. In that case, however, the deficit cannot reduce the adjusted basis of the asset below zero.

Under prior law and under the Act, subpart F inclusions increase stock basis in but do not decrease earnings and profits of a controlled foreign corporation (secs. 961 and 959). Congress did not intend that the addition of such amounts to stock basis by virtue of a subpart F inclusion (or another inclusion with an equivalent effect on basis) result in double counting.

This adjustment to asset value on a look-through basis is also to apply to stock of foreign corporations that is not directly held by U.S. taxpayers but that is indirectly 10-percent owned by U.S. taxpayers. For example, if a U.S. corporation owns a first-tier foreign corporation that owns a second-tier foreign corporation, the U.S. corporation is to increase the asset basis to which it allocates expenses by its share of earnings and profits accumulated while the taxpayer held, indirectly or directly, 10 percent or more of that stock in the second-tier foreign corporation.

The Act's one-taxpayer rule also provides new treatment under the asset method for stock in affiliated U.S. companies. Congress intended that stock of affiliates and intercompany debt between domestic affiliates be disregarded under appropriate look-through rules prescribed by the Secretary. Under this approach, for example, as members of an affiliated U.S. group earn income that they retain, those earnings and profits will be reflected in assets whose tax basis will be considered in the allocation of expenses. In this respect, this look-through treatment is comparable to the treatment that the Act provides for stock of foreign corporations that pay dividends eligible for the deemed-paid foreign tax credits and for stock of unaffiliated U.S. corporations.

Example

An example illustrates the operation of the one-taxpayer rule and the asset method change. A U.S. parent company has borrowed $360 from an unrelated party with an obligation to pay annual interest of $36. The U.S. parent borrower owns two assets. One of its assets is stock of a wholly-owned domestic subsidiary; that stock has a basis in the parent's hands of $600. The U.S. subsidiary in turn owns the following assets: U.S. assets which have a basis in its hands of $700, and foreign assets which have a basis in its hands of $100. The other asset of the U.S. parent (the borrower) is all the stock of a foreign corporation. The basis of the stock in the foreign corporation in the hands of the U.S. owner is $100. The foreign corporation also has earnings and profits of $100. The foreign corporation has assets with a basis in its hands of $200.

Under the Act, after a transition period, the interest expense allocation rules operate on the basis of the affiliated group consisting of the U.S. parent corporation and its U.S. subsidiary. The parent is treated in effect as owning directly the $700 of U.S. assets owned by the U.S. subsidiary and the $100 of foreign assets owned by the U.S. subsidiary (the stock investment is eliminated for this purpose). In addition, the parent is treated as owning $200 of foreign assets by virtue of its $100 basis in the stock of the foreign subsidiary increased by the $100 of earnings and profits of the foreign subsidiary. Thus, the parent is treated as owning $700 of U.S. assets and $300 of foreign assets for purposes of the Act's rules. Therefore, 70 percent of its interest expense ($700/$1000) reduces U.S. source gross income. The parent corporation allocates $10.80 (30 percent of $36) against foreign source income and $25.20 (70 percent of $36) against U.S. source income. The same result would obtain if the U.S. subsidiary had borrowed the money and paid the interest.

Regulations

The Act requires the Secretary to prescribe such regulations as may be necessary to carry out the purposes of these provisions. These regulations are to include regulations providing for the resourcing of income of any member of an affiliated group or modifications to the consolidated return regulations to the extent such resourcing or modification is necessary to carry out the purposes of this section. In particular, Congress intended that, in the case of an affiliated group of corporations that is eligible to file a consolidated return but that does not do so, the foreign source income of any member of the group may not exceed the amount of foreign source income that would be attributable to that member if the group were a single corporation. For example, assume that two U.S. corporations, a parent corporation and its wholly owned subsidiary, although eligible to file a consolidated return, do not do so. The parent has $20 of gross income, all from sources within the United States, and incurs $20 of interest expense. The parent has no net income after interest expense. The subsidiary has $20 of gross income, all from sources outside the United States, and incurs no interest expense. The subsidiary has $20 of net income. Congress intended that under regulations the foreign source income of this group of two corporations not exceed what it would have been had they filed a consolidated return. Had they done so, the group would have had $10 of net U.S. source income, and $10 of net foreign source income. Therefore, the foreign source income of the subsidiary cannot exceed $10. It will be treated as earning $10 of U.S. source income and $10 of foreign source income.

In addition, Congress intended that regulations provide appropriate safeguards to prevent the transfer of assets from one consolidated group member to another to achieve a fair market value basis without recognition of gain (until the asset leaves the group).

In addition, Congress intended that regulations provide for the apportionment of interest allocated to foreign source income among the various categories of foreign source income described in section 904(d)(1), such as passive income and active (overall limitation) income. The rules for apportioning expenses among baskets of income for foreign tax credit limitation purposes are to be consistent with those used for source purposes.

As discussed above under "Interest expenses," Congress also provided explicit regulatory authority for direct allocation of interest expense incurred to carry out an integrated financial transaction.

Effective Date

In general, these provisions apply to taxable years beginning after December 31, 1986. Transitional rules apply to the allocation of interest expense, however.

The Act adopts certain transition rules for taxable years beginning after 1986 with respect to interest expenses incurred with respect to the amount of debt outstanding at specified dates prior to enactment. For the purpose of all the provision's phase-in rules for interest expense, only interest-bearing indebtedness is considered as debt outstanding on any specified date. If a portion of a taxpayer's debt is not eligible for the benefits of a phase-in rule, the benefits of the rule apply to interest incurred with respect to each of the taxpayer's outstanding interest-bearing debt obligations on a pro rata basis. For each of these rules, all members of the same affiliated group of corporations (as defined for purposes of new Code sec. 864(e)) are to be treated as one taxpayer.[11]

A general 3-year "phase-in" rule applies to all modifications to interest expense apportionment (including the change to consider an affiliated group as one taxpayer, the elimination of the gross income method, and the changes to the asset method). This "phase-in" rule provides that for the first three taxable years of the taxpayer beginning after December 31, 1986, the Act's rules do not apply to interest on an applicable percentage of the amount of indebtedness outstanding on November 16, 1985.

The 3-year phase-in rule applies whether the taxpayer borrows from the same unrelated lender to which it was indebted on November 16, 1985, or from other unrelated lenders. For the first taxable year, the applicable percentage is 75 percent; for the second taxable year, the applicable percentage is 50 percent; and for the third taxable year, the applicable percentage is 25 percent.[12]

Thus, for example, under the 3-year "phase-in," if a calendar year taxpayer's interest-bearing debt outstanding on November 16, 1985, was $100, and its interest-bearing debt outstanding at all times during 1987 is $75, the Act will not affect interest expenses paid or accrued during 1987. The principles of this example are intended to apply to all the Act's transitional rules governing interest expense, including the 4- and 5-year rules and the targeted ten-year rules.

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[11] A technical correction may be needed so that the statute reflects this intent with respect to the 3-year and targeted 10-year transition rules.

[12] A technical correction may be needed so that the statute reflects this intent.

An additional transitional provision applies only to the one-taxpayer rule, *i.e.*, the rule requiring consideration of the affiliated group as one taxpayer for determination of interest expense (new sec. 864(e)(1)). That provision gives relief from the one-taxpayer rule for recently incurred portions of the amount that was outstanding on November 16, 1985. In the case of an increase in the amount of a taxpayer's outstanding debt on May 29, 1985, over the amount of the taxpayer's outstanding debt on December 31, 1983, the one-taxpayer rule is phased in over five years. In the case of the first taxable year beginning after 1986, with respect to the excess of the May 29, 1985 amount over the December 31, 1983 amount, the one-taxpayer rule applies to the interest expenses paid or accrued by the taxpayer on 16⅔ percent of that excess, and not to the other 83⅓ of that excess. In the case of the second taxable year beginning after 1986, with respect to the excess of the May 29, 1985 amount over the December 31, 1983 amount, the one-taxpayer rule applies to the interest expenses paid or accrued by the taxpayer on 33⅓ percent of that excess, and not to the other 66⅔ of that excess, and so on, until the one-taxpayer rule applies to 83⅓ percent of the excess in the fifth taxable year beginning after 1986, and to all interest expenses thereafter.

A similar separate 4-year "phase-in" rule applies to certain increases in indebtedness incurred during 1983. For the first four taxable years of the taxpayer beginning after 1986, with respect to interest expenses attributable to the excess of the amount of the outstanding debt of the taxpayer on January 1, 1984, over the amount of the outstanding debt of the taxpayer on December 31, 1982, the one-taxpayer rule will apply only to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an applicable percentage of that excess. For the first taxable year, the applicable percentage is 20; the second year, 40; the third year, 60; and the fourth year, 80.

For the purpose of the 5-year phase-in and the 4-year phase-in, any indebtedness outstanding on November 16, 1985 shall be treated as attributable first to the excess incurred after 1983 but before May 29, 1985 (and thus eligible for the 5-year phase-in), then to indebtedness incurred in 1983 (and thus eligible for the 4-year phase-in), and then to other indebtedness outstanding as of November 16, 1985.

The 3-, 4-, and 5-year phase-in rules apply to interest expenses paid or accrued with respect to an applicable amount of indebtedness. These rules allow prior law to apply to interest expenses on a certain percentage of such indebtedness. The phase-in rules are intended to benefit an amount of debt that continues to be outstanding. Thus, when the amount of a taxpayer's debt decreases and thereafter increases, only the amount that continues to be outstanding is eligible for phase-in relief. The reason for this ratchet-down of benefits is to allow taxpayers relief for obligations they maintain, but not for new obligations that finance new undertakings. If, for example, a taxpayer refinances debt that was outstanding on November 16, 1985 by incurring new debt with which it pays off old debt, the phase-in rules are intended to apply to the new debt, whether or not the documentation for the new debt specifically identifies the old debt being refinanced.

In the case of a company that acquires another company after November 16, 1985, the debt of the target and acquirer are aggregated in determining the amount of debt qualifying for transition relief. For example, if a corporation with $50 of debt outstanding on that date acquires on June 1, 1986, another corporation that had $20 of debt outstanding on November 16, 1985, and none of that debt was owed from one of these corporations (or by parties related to it) to the other (or to parties related to it), then the amount of debt of the group qualifying for transitional relief is $70.

In addition, certain special effective date rules are provided.

Congress did not intend that application of the 3-year phase-in rule prevent the application of the 4- or 5-year rule (or vice versa).[13] The following example involves the application of two different transitional rules (the 5-year phase-in for the one taxpayer rule and the 3-year phase-in for the other rules) for interest expense allocation.

A U.S. parent company, a calendar year taxpayer, had outstanding interest-bearing debt of $180 from 1980 until December 31, 1983. That debt bore and bears annual interest of 10 percent ($18). On July 1, 1984, it borrowed an additional $180 from a third party with an obligation to pay annual interest of $18. At all times after 1986 the borrower owns two assets. One of its assets is stock of a domestic subsidiary; that stock has a basis in the parent's hands of $800. The U.S. subsidiary in turn owns the following assets: U.S. assets which at all times have a basis in its hands of $700, and foreign assets which at all times have a basis in its hands of $100. The other asset of the U.S. parent (the borrower) is stock in a foreign corporation. At all times the basis of the stock in the foreign corporation in the hands of the U.S. owner is $100. At all times relevant to this example the foreign corporation has earnings and profits of $100.

The U.S. parent corporation's third party debt was $360 on July 1, 1984, and at all times thereafter relevant to this example (including November 16, 1985 and all of the first taxable year beginning after 1986). The U.S. parent corporation is entitled to use both the 3-year transition rule, because the $360 was outstanding on November 16, 1985, and the 5-year rule, because $180 was incurred in 1984.

For the first taxable year beginning after 1986, the 5-year transition rule prevents application of the 1-taxpayer rule to 83⅓ percent of the $180 debt. That is, the 1-taxpayer rule cannot apply to $150 of the debt. The 3-year transition rule prevents application of any of the Act's interest expense allocation rules to 75 percent of the $360 debt. That is, none of the new rules can apply to $270 of the debt.

In cases where an amount of a taxpayer's debt (before application of the phase-down percentages) qualifies for relief from one-taxpayer treatment under both the 3-year rule and either the 4- or 5-year rule, Congress intended that relief from one-taxpayer treatment under the more beneficial rule (the 4- or 5-year rule) supersede the relief available under the less beneficial rule (the 3-year rule). Relief under the 4- or 5-year rule is to apply to debt that would have benefited from the 3-year rule absent this supersession, to the extent possible. Thus, in this example, with respect to $180 of debt, the 5-year rule provides relief for 83⅓ percent ($150) from one-taxpayer treatment. With respect to one-taxpayer treatment for that same $180, the 5-year rule applies in lieu of the 3-year rule. For this $180, with respect to the Act's modifications other than one-taxpayer treatment, the 3-year rule applies to $135 of the $150 for which the 5-year rule provides one-taxpayer treatment. Thus, with respect to the $180 eligible for 5-year relief, interest on $135 is fully grandfathered, interest on $15 is apportioned on a separate company basis (but under the rules of the Act other than the one-taxpayer rule), and interest on $30 is apportioned under new law.

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[13] A technical correction may be needed so that the statute reflects this intent.

As to the $180 not eligible for 5-year relief but eligible for 3-year relief, interest on 75 percent ($135) is fully grandfathered, while interest on 25 percent ($45) is apportioned under new law.

In total, then, interest on $270 is fully grandfathered, interest on $15 is apportioned on a separate company basis (but under the rules of the Act other than the one-taxpayer rule), and interest on $75 is apportioned under new law.

The bill's 3-year transitional rule treats the interest on $270 of debt, $27, under the rules of prior law. For this purpose, the U.S. parent borrower uses the asset method of allocating interest expense. It has assets with a basis in its hands of $800 that generate U.S. source income. The stock of its domestic subsidiary pays only U.S. source dividends to the parent, so it is treated as a purely domestic asset for this prior-law computation. The stock of the foreign corporation, with the basis in the parent's hands of $100, is treated as a foreign asset. Therefore, 8/9ths of the parent's interest expense ($800/$900) offsets U.S. source income, while 1/9 of the parent's interest expense ($100/$900) offsets foreign source income. Therefore, $24 of the interest expense governed by this rule (8/9 of $27) offsets U.S. source income while $3 of interest expense (1/9 of $27) offsets foreign source income under this prior-law computation.

In this example, the Act's transitional rules treat the $1.50 interest on $15 of debt under the Act's rules for the allocation of interest expense, other than the one-taxpayer rule, fully phased-in. For the purpose of this example, the only rule involved other than the one-taxpayer rule is the new asset method. Use of the asset method (fully phased-in) would result in the U.S. parent borrower treating the stock of its foreign subsidiary as having a value of $200, which represents $100 of original basis and $100 of earnings and profits. (The U.S. parent treats the stock of its U.S. subsidiary as consisting solely of U.S. assets, because the asset method modification does not require a look-through to the underlying assets of members of the U.S. affiliated group. Only the affiliated group change, that is, the one-taxpayer rule, looks through to those assets). Therefore, the U.S. parent is treated, for this step in applying this transition rule, as owning $800 of U.S. assets and $200 of foreign assets. Therefore, for this step, it allocates 80 percent of the $1.50 interest expense at issue, or $1.20, against U.S. income, and the other 20 percent of the $1.50 interest expense at issue, or $.30, against foreign income.

The $7.50 interest expense attributable to the $75 of debt that is not eligible for any phase-in relief is allocated on the basis of the affiliated group consisting of the U.S. parent corporation and its U.S. subsidiary. The parent will be treated in effect as owning directly the $700 of U.S. assets owned by the U.S. subsidiary and the $100 of foreign assets owned by the U.S. subsidiary. The parent will be treated as owning an additional $200 of foreign assets by virtue of its $100 basis in the stock of the foreign subsidiary increased by the $100 of earnings and profits in the hands of the foreign subsidiary. Thus, the parent has $700 of U.S. assets and $300 of foreign assets for the purpose of expense allocation. Therefore, 70 percent of this $7.50 of interest expense ($700/$1000) will reduce U.S. source gross income. The parent corporation will allocate $2.25 (30 percent of this $7.50) against foreign source income and $5.25 (70 percent of this $7.50) against U.S. source income.

Thus, for calendar year 1987, the taxpayer allocates $5.55 (the sum of $3, $.30, and $2.25) against foreign source income and $30.45 (the sum of $24, $1.20 and $5.25) against U.S. source income.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $174 million in 1987, $428 million in 1988, $686 million in 1989, $858 million in 1990, and $1,113 million in 1991.

6. One-year modification in regulations providing for allocation of research and experimental expenditures (sec. 1216 of the Act) [14]

Prior Law

Foreign tax credit and source rules

All income has either a U.S. source or a foreign source. The foreign tax credit can offset U.S. tax on foreign source taxable income, but not tax on U.S. source taxable income. (This is known as the foreign tax credit limitation.) A shift in the source of income from foreign to U.S. may increase U.S. tax by reducing the foreign tax credit limitation.

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, Code sections 861-863 require taxpayers to apportion expenses between foreign source income and U.S. source income. A shift in the apportionment of expenses from U.S. to foreign source gross income decreases foreign source taxable income. This decrease may increase U.S. tax by reducing the foreign tax credit limitation.

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[14] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 616; H.Rep. 99-426, pp. 383-388; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1303; S.Rep. 99-313, pp. 703-707; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 608 (Conference Report).

Research and experimental expense allocation regulation

Treasury Regulation section 1.861-8 (issued in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expenses"). The regulation provides that research expenses are ordinarily considered definitely related to all gross income reasonably connected with one or more of 32 product categories based on two-digit classifications of the Standard Industrial Classification ("SIC") system. Research expenses are not traced solely to the income generated by the particular product which benefited from the research activity. Instead, these expenses are associated with all the income within the SIC product group in which the product is classified.

The Treasury regulation contemplates that taxpayers will sometimes undertake research solely to meet legal requirements imposed by a particular political entity with respect to improvement or marketing of specific products or processes. In some cases, such research cannot reasonably be expected to generate income (beyond de minimis amounts) outside that political entity's jurisdiction. If so, the associated research expense reduces gross income only from the geographic source that includes that jurisdiction.

After research expenses incurred to meet legal requirements are allocated under the above rule, any remaining research expenses are generally apportioned to foreign source income based on the ratio of total foreign source sales receipts in the SIC product group with which the expenses are identified to the taxpayer's total worldwide sales receipts in that product group (the "sales" or "gross receipts" method). In computing this fraction, sales of a party controlled or uncontrolled by the taxpayer are taken into account if the party can reasonably be expected to benefit from the research expense. However, the regulation provides that a taxpayer using the sales method may first apportion 30 percent of research expense remaining after allocation to meet legal requirements exclusively to income from the geographic source where over half of the taxpayer's research and development is performed.

Thus, for example, a taxpayer which performs 50 percent or more of its research and development in the United States may automatically apportion at least 30 percent of its remaining research expense to U.S. source income. A taxpayer can choose to apportion to the geographic source where research and development is performed a percentage of research expense significantly greater than 30 percent if the taxpayer establishes that the higher percentage is warranted because the research and development is reasonably expected to have a very limited or long-delayed application outside that geographic source.

Alternatively, subject to certain limitations, a taxpayer may elect to apportion its research expense remaining after any allocation to meet legal requirements under one of two optional gross income methods. Under these optional methods, a taxpayer generally apportions its research expense on the basis of relative amounts of gross income from U.S. and foreign sources. If a taxpayer makes an automatic place-of-performance apportionment, the taxpayer may not use an optional gross income method.

The basic limitation on the use of the optional gross income methods is that the respective portions of a taxpayer's research expense apportioned to U.S. and foreign source income using these methods could not be less than 50 percent of the respective portions that would be apportioned to each income grouping using a combination of the sales and place-of-performance apportionment methods.

If this 50-percent limitation is satisfied with respect to both income groupings, the taxpayer may apportion the amount of its research expense that remains after allocation under the legal requirements test ratably on the basis of foreign and U.S. gross income. If the 50-percent limitation is not satisfied with respect to one of the income groupings, then the taxpayer apportions to that income grouping 50 percent of the amount of its research expense which would have been apportioned to that income grouping under the sales and place-of-performance methods. A taxpayer electing an optional gross income method may be able then to reduce the amount of its research expense apportioned to foreign source income to as little as one-half of the amount that would be apportioned to foreign source income under the sales method.

For example, consider a taxpayer with $110 of U.S.-performed research expense and equal U.S. and foreign sales. Assume that $10 of the research expense is to meet U.S. legal requirements and is allocated to U.S. source income. Of the remaining $100, 30 percent ($30) was exclusively apportioned to U.S. source income under the automatic place-of-performance rule and the remaining $70 was divided evenly between U.S. and foreign source income, using the sales method. Thus, under this method $35 would be allocated to foreign source income and $75 would be allocated to U.S. source income. Under the optional gross income methods, the $35 of research expense allocated to foreign sources could have been reduced as much as 50 percent, to $17.50. This could have occurred, for example, if the foreign sales were made by a foreign subsidiary that did not repatriate earnings to the U.S. corporation.

The optional gross income methods apply to all of a taxpayer's gross income, not gross income on a product category basis.

Temporary moratorium and Treasury study

The Economic Recovery Tax Act of 1981 (ERTA) provided that, for a taxpayer's first two taxable years beginning after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of sec. 174) paid or incurred in those years for research activities conducted in the United States were to be allocated or apportioned to income from sources within the United States (sec. 223 of ERTA).

This two-year moratorium was effectively extended for two additional years by the Tax Reform Act of 1984. Under section 126 of the 1984 Act, for taxable years beginning generally after August 13, 1983, and on or before August 1, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of sec. 174) attributable to research activities conducted in the United States are to be allocated to sources within the United States for purposes of computing taxable income from U.S. sources and from sources partly within and partly outside the United States.

One reason Congress cited for enacting the original two-year moratorium was that some foreign countries do not allow deductions under their tax laws for expenses of research activities conducted in the United States. Taxpayers argued that this disallowance caused U.S.-based research to be disadvantaged. First, U.S.-based research expense is deemed to be allocated to a foreign country which may not recognize that such amount is deductible as an expense. The allocation of this U.S.-based research expense to foreign sources had the effect of reducing the U.S. taxpayer's foreign tax credit. Because those taxpayers could take their deductions if the research occurred in the foreign country, taxpayers argued that there was an incentive to shift their research expenditures to those foreign countries whose laws disallow tax deductions for research activities conducted in the United States but allow tax deductions for research expenditures incurred locally.

Accordingly, Congress concluded that the Treasury Department should study the impact of the allocation of research expenses under the 1977 regulation on U.S.-based research activities and on the availability of the foreign tax credit. Pending the outcome of the study, Congress concluded that expenses should be charged to the cost of generating U.S. source income, whether such research was a direct or indirect cost of producing foreign source income.

On the ground that a reduction in research and development might adversely affect the competitive position of the United States, the 1983 Treasury report recommended the two-year extension of the moratorium that was ultimately enacted by Congress in 1984. The extension was intended to allow Congress to consider further the results of the Treasury study.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272) extended the moratorium on the application of the research and experimental expense allocation rules of the 1977 regulation generally for one additional taxable year beginning after August 1, 1985, and on or before August 1, 1986.

Reasons for Change

Prior moratoria on the application of the Treasury research expense regulation allocation rules were intended to encourage the performance of research in the United States. Congress believed that the Federal tax law should generally encourage U.S.-based research activity.

Because of the importance of U.S.-based research activity, Congress again delayed application of the Treasury research expense regulation allocation rules so they could continue to study whether any additional permanent tax incentives for U.S. research are appropriate. Congress considered it important that the relative equity and efficiency of alternative tax incentives be fully analyzed before any decision is made to adopt an additional permanent tax incentive. While Congress studies these issues further (for a one-year period), the Act provides temporary rules for allocation of research expense that are based on the approach of the Treasury regulation, but that liberalize the Treasury regulation in certain respects. These temporary modifications to the regulation's allocation rules are intended to provide an additional tax incentive to conduct research in the United States while Congress analyzes whether any additional permanent incentive is necessary.

The Act's further delay in implementing the Treasury regulation does not reflect a determination by Congress that any provision of the existing regulation is necessarily correct or incorrect. Instead, it is anticipated that the Treasury Department will expeditiously pursue a permanent resolution of the allocation issue. Congress did, however, intend that the Treasury Department reexamine its regulations in light of concerns expressed by the tax-writing committees of both Houses of Congress.

Explanation of Provision

Under the Act, the moratorium on application of the research expense allocation rules in Treasury Regulation 1.861-8 is permitted to expire. However, for taxable years beginning after August 1, 1986, and on or before August 1, 1987, application of the regulation is liberalized in three respects. These liberalizations apply without regard to other changes made by the Act in the Code's expense allocation rules.

Under reg. sec. 1.861-8(e)(3)(i)(B), research expenditures are allocated entirely to one geographic source if they were incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes and cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source. This rule is unaffected by the Act. The first liberalization under the Act is that for the specified one-year period, the Act provides that 50 percent of all remaining amounts allowable as a deduction for qualified research and experimental expenditures may be apportioned to U.S. source income and deducted from such income in determining the amount of taxable U.S. source income. The Act thus has the effect of increasing the automatic place-of-performance apportionment percentage for U.S.-based research expense from 30 percent to 50 percent. Under the Act, a taxpayer will be able automatically to apportion to U.S. source income 50 percent of its U.S.-based research expense remaining after any allocation of such expense incurred to meet legal requirements.

The Act further provides that, for the specified one-year period, the portion of those amounts allowable as a deduction for qualified research and experimental expenditures that remains after any legal requirements allocation and the 50-percent automatic place-of-performance apportionment will be apportioned either on the basis of sales or gross income. Thus, the Act's second effective liberalization of the regulation is to allow the automatic place-of-performance apportionment temporarily to taxpayers who elect to apportion expenses using the optional gross income method, rather than only to taxpayers that use the standard sales method of apportionment. Third, the Act has the effect of temporarily suspending the regulatory rule that prohibits taxpayers from using the optional gross income method to reduce allocation of research expense to foreign source income by more than 50 percent over what the allocation to foreign source income would be under the sales method.

The temporary modifications made by the Act to the research expense allocation rules in Treasury Regulation section 1.861-8 apply for purposes of computing taxable income from U.S. sources and from sources partly within and partly outside the United States. The modifications apply only to the allocation of research and experimental expenditures for the purposes of geographic sourcing of income; the modifications do not apply for other purposes, such as the computation of combined taxable income of a FSC (or DISC) and its related supplier. Also, the modifications do not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation.

Effective Date

The provision applies to taxable years beginning after August 1, 1986, and on or before August 1, 1987 only.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $252 million in 1987, and $149 million in 1988.

C. U.S. Taxation of Income Earned Through Foreign Corporations

1. Subpart F income subject to current taxation (secs. 1221 and 1227 of the Act and secs. 864, 952, 953, 954, 955, and 957 of the Code)[1]

Prior Law

In general

Two different sets of U.S. tax rules apply to American taxpayers that control business operations in foreign countries. Which rules apply depends on whether the business operations are conducted directly, for example, through a foreign branch, or indirectly through a separately incorporated foreign company. (To the extent that foreign corporations operate in the United States rather than in foreign countries, they generally pay U.S. tax like U.S. corporations.)

Direct operations—current tax

U.S. persons that conduct foreign operations directly (that is, not through a foreign corporation) include income from those operations on the U.S. tax return for the year they earn it. The United States taxes that income currently. The foreign tax credit (discussed above at A.) may reduce or eliminate the U.S. tax on that income, however.

Indirect operations—generally tax deferral

U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation sends its income home to America (repatriates it). The income appears on the U.S. owner's tax return for the year it comes home, and the United States imposes tax on it then. The foreign tax credit may reduce or eliminate the U.S. tax, however. (The foreign corporation itself generally will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.)

In general, two kinds of transactions are repatriations that end deferral and trigger tax. First, an actual dividend payment ends deferral: any U.S. recipient must include the dividend in income. Second, in the case of a controlled foreign corporation, an investment in U.S. property, such as a loan to the lender's U.S. parent or the purchase of U.S. real estate, is also a repatriation that ends deferral (Code sec. 956). In addition to these two forms of repatriation, a sale of shares of a foreign corporation triggers tax, sometimes at ordinary income rates (sec. 1248 or sec. 1246).

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 622; H.Rep. 99-426, pp. 389-401; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 921 and 989; S.Rep. 99-313, pp. 361-70; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 609-26 (Conference Report).

Indirect operations—current tax for some income

Deferral of U.S. tax on income of a controlled foreign corporation is not available for certain kinds of income (sometimes referred to here as "subpart F income") under the Code's subpart F provisions. When a U.S.-controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats the U.S. shareholders as having received a current distribution out of the subpart F income. In this case, too, the foreign tax credit may reduce or eliminate the U.S. tax.

Subpart F income is generally income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. Subpart F income is not limited to those kinds of income, however. Under prior law, subpart F income consisted of income from the insurance of U.S. risks (defined in old sec. 953), foreign base company income (defined in sec. 954), and certain income relating to international boycotts and illegal payments.

Under present and prior law, foreign base company income is itself subdivided into five categories. One major category is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally consisted under prior law of passive income such as interest, dividends, net gains from sales of stock and securities, related party factoring income, and some rents and royalties. Net gains from certain commodities futures transactions were foreign personal holding company income unless they arose out of certain bona fide hedging transactions.

An exclusion from subpart F foreign personal holding company income is provided under present and prior law for rents and royalties received in the active conduct of a trade or business from unrelated persons. Under this active trade or business test, rents from a retail car-leasing business involving substantial maintenance, repair, and marketing activities, for example, are excluded from subpart F, while rental income from lease-financing transactions is not.

Exclusions from subpart F foreign personal holding company income were provided under prior law for dividends, interest, and gains derived from unrelated persons by a banking, financing, or similar business, and dividends, interest, and gains received by an insurance company from its investment of unearned premiums and reserves. An additional exclusion was provided for interest paid between related persons that were each engaged in the conduct of a banking, financing, or similar business predominantly with unrelated persons. Present and prior law also exclude from subpart F income certain dividends and interest received from a related person organized and operating in the same foreign country as the recipient, and certain rents and royalties received from a related person for the use of property within the country in which the recipient was created or organized.

Under present and prior law, other categories of foreign base company income include foreign base company sales and services income, consisting respectively of income from related party sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. Income from the insurance of related parties' third-country risks was taxed as foreign base company services income under prior law. Foreign corporations' earnings from insuring foreign risks of unrelated persons were not subject to current U.S. tax under prior law's subpart F rules.

Foreign base company income also includes foreign base company shipping income. However, under prior law, foreign base company shipping income that was reinvested by a controlled foreign corporation in foreign shipping operations was excluded from foreign base company income.

Finally, under present and prior law, foreign base company income generally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income.

Income otherwise subject to current taxation as foreign base company income could be excluded from subpart F under prior law if it were established that reducing taxes was not a significant purpose of earning the income through a controlled foreign corporation. The regulations implementing this rule provided objective tests that could be used to determine whether a controlled foreign corporation was used to reduce tax. For example, the regulations provided that if foreign personal holding company income was subject to tax in the controlled foreign corporation's country of incorporation at an effective rate that was at least 90 percent of (or not more than five percentage points less than) the U.S. rate, then the controlled foreign corporation was not used to reduce tax.

Under present and prior law, a controlled foreign corporation's subpart F income cannot exceed its earnings and profits for the year. Under this rule, current deficits in earnings and profits in any income category, including nonsubpart F income categories, reduce subpart F earnings and profits and, thus, subpart F income. Under the same provision (before its amendment by the Act), a controlled foreign corporation's deficits in earnings and profits from prior years reduced its subpart F income in the current year. Under the "chain deficit" rule of prior law, if a controlled foreign corporation had a current deficit in earnings and profits, then another commonly controlled foreign corporation in the same chain of ownership could have its current earnings and profits reduced for subpart F purposes to take into account that deficit.

Reasons for Change

Overview

It has long been the policy of the United States to impose current tax when a significant purpose of earning income through a foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of U.S. persons' operations and investments. Because movable income earned through a foreign corporation could often be earned through a domestic corporation instead, Congress believed that a major motivation of U.S. persons in earning such income through foreign corporate vehicles often was the tax benefit expected to be gained thereby. Congress believed that it was generally appropriate to impose current U.S. tax on such income earned through a controlled foreign corporation, since there is likely to be limited economic reason for the U.S. person's use of a foreign corporation. Congress believed that by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices would be placed on a more even footing, thus encouraging more efficient (rather than more tax-favored) uses of capital.

In Congress' view, several of the exceptions to current taxation under subpart F were excessively broad under prior law. Congress believed that those exceptions often inappropriately permitted U.S. taxpayers to defer U.S. taxation of several types of income by earning such income through a foreign corporation. Deferral of U.S. tax on the foreign income of a U.S.-controlled foreign corporation generally is inappropriate when the corporation functions to shift income to a jurisdiction in which it generates tax benefits for the U.S. shareholders. In particular, Congress believed that the following types of income could sometimes be earned through a foreign corporation in a tax haven country that bears limited substantive economic relation to the income, and that continued deferral of U.S. tax on such income would encourage the movement of the associated operations abroad at the U.S. Treasury's expense.

Sales of property which does not generate active income

Under prior law, foreign personal holding company income subject to current U.S. taxation when earned by a controlled foreign corporation included the excess of gains over losses from sales and exchanges of all stock and securities (except in the case of regular dealers). Thus, U.S. shareholders of a controlled foreign corporation were subject to current taxation not only on the dividends and interest generated by stock and securities (with certain exceptions for payments from active related parties in the same country) but also on the net gain realized when these stocks and securities were disposed of (without any same country exception). However, under prior law, investment property other than stock and securities was not subject to current tax when disposed of. Congress believed that this inconsistency should be eliminated, and concluded that a more logical approach was to tax currently net gains on the disposition of other noninventory property which gives rise to passive income (under the foreign personal holding company provisions of subpart F) or is non-income producing. Thus, for example, a controlled foreign corporation's disposition of a patent or license (not used in the active conduct of a trade or business) should be subject to current U.S. taxation to the corporation's U.S. shareholders.

Commodities transactions

Under prior law, foreign personal holding company income subject to current U.S. taxation when earned by a controlled foreign corporation included the excess of gains over losses from futures transactions in any commodity (with a hedging exception). Congress believed that the limitation of this rule to commodities futures transactions inappropriately excluded from subpart F gains realized by passive investors in commodities contracts other than futures contracts. Congress thus concluded that net income from all commodities transactions should generally be subject to current U.S. taxation under subpart F. However, Congress recognized that commodities transactions may constitute an integral part of the active business of a producer, processor, merchant, or handler of commodities. Just as many futures transactions of such persons were generally excluded from foreign personal holding company income (under prior law's hedging exception), non-futures transactions of such persons should be excluded from subpart F taxation under a similar rule.

Foreign currency gains

Congress enacted subpart F in 1962 when currency exchange rates generally were fixed. Since the advent of floating exchange rates in the early 1970's, taxpayers have more frequently realized foreign currency gains and losses. In connection with its general clarification of the tax rules governing foreign currency exchange rate gains and losses (see F., below), Congress believed that certain currency gains and losses should be subjected to tax under subpart F. Congress believed that income from trading in foreign currencies represents the type of income that can easily be routed through a controlled foreign corporation in a tax haven jurisdiction. Therefore, the excess of foreign currency exchange rate gains over foreign currency exchange rate losses should generally be subject to current U.S. taxation under subpart F, unless directly related to the business needs of the corporation.

Dividends, interest, and securities gains of banking and insurance businesses

Under present and prior law, dividends, interest, and gains from sales of stock and securities are generally treated as foreign personal holding company income subject to current taxation under subpart F. However, under prior law, when such income was received from unrelated persons in the conduct of a banking, financing, or similar business, it was not subjected to current taxation. Similarly, such income was excluded from foreign personal holding company income when it was derived from an insurance company's investments of unearned premiums, ordinary and necessary reserves, and certain other funds. Congress believed that these exceptions often provided excessive opportunities for taxpayers to route income through foreign countries to maximize U.S. tax benefits. The lending of money is an activity that can often be located in any convenient jurisdiction, simply by incorporating an entity in that jurisdiction and booking loans through that entity, even if the source of the funds, the use of the funds, and substantial activities connected with the loans are located elsewhere. The proliferation of U.S.-controlled banking and insurance companies in various tax haven jurisdictions suggested that many taxpayers were in fact taking advantage of the ability to earn dividends, interest, and gains through such entities, on which the U.S. tax was deferred and the foreign tax was often insignificant.

Because dividends, interest, and gains on the sale of stock and securities are inherently manipulable, Congress concluded that it was inappropriate to allow continued deferral with respect to such income that is earned through a controlled foreign corporation, regardless of the nature of the business earning such income. Thus, Congress determined that dividends, interest, and gains from the disposition of stock or securities generally should be treated as foreign personal holding company income subject to current U.S. taxation under subpart F, regardless of whether the corporation receiving such income is engaged in a banking, financing, or insurance business. Congress believed, however, that it was appropriate to retain tax deferral available under prior law with respect to a limited category of export finance-related interest derived in the conduct of a banking business.

Income equivalent to interest

To prevent taxpayers from continuing (notwithstanding the Act's separate limitation for passive income and other amendments to the definition of subpart F foreign personal holding company income) to shelter passive interest-type income from current U.S. tax by rearranging the form of offshore passive investments so that the income they generate is not traditional interest income, Congress decided to treat income equivalent to interest as subpart F foreign personal holding company income (and passive income, for separate limitation purposes).

Related person exceptions

Under prior law, foreign personal holding company income did not include dividends and interest received from a related person organized and operating in the same foreign country as the recipient, interest paid between related persons engaged in the conduct of a banking, financing, or similar business, or rents and royalties received from a related person for the use of property within the country in which the recipient was created or organized. Thus, for example, interest paid by a sales subsidiary to a holding company organized in the same foreign country generally was not treated as foreign personal holding company income subject to current tax under subpart F.

The exceptions for interest, rent, and royalty payments could be manipulated to avoid current U.S. taxation of tax haven income. For example, if one company in a group earned subpart F income, but paid interest to a related company in the same foreign country, the deduction for the interest paid to the related company could reduce the first company's subpart F income while, at the same time, the interest was not considered tax haven income to the second company because of the same country interest exception. Thus, intercompany payments that benefited from the same country exceptions could reduce the total tax haven income of a group of related companies. Congress therefore concluded that the above exceptions should be limited by a rule that looks through to the nature of the income earned by the payor. In addition, Congress believed that the related party banking exception should be repealed, consistent with the repeal of the general exemption for dividends, interest, and gains from sales of stock and securities derived from unrelated persons in a banking, financing, or similar business.

Insurance income in general

Under prior law, income from the insurance of U.S. risks was subject to current taxation under subpart F, as was income from the insurance of related persons' risks in countries outside the insurer's country of incorporation. Congress believed that income from the insurance of risks outside the insurer's country of incorporation should be subject to current taxation regardless of whether the risks are located in the United States and regardless of whether the insured is a related person. Insurance income generally represents the type of inherently movable income at which subpart F is aimed, since such income can frequently be routed through a corporation formed in any convenient jurisdiction. (Indeed, several countries have promoted themselves as jurisdictions for the formation of such corporations.) When a controlled foreign corporation insures risks outside of the country in which the corporation is organized, then it is appropriate to treat that income as if it has been routed through that jurisdiction primarily for tax reasons, regardless of whether the insured is a related or unrelated person. In all such cases, it is appropriate to impose current U.S. taxation under subpart F.

Under prior law, income from a controlled foreign company's insurance of U.S. risks was excluded from subpart F under a de minimis rule if it accounted for less than 5 percent of the corporation's premium-type income. Congress determined that such a rule was no longer appropriate in the context of a provision that taxes a controlled foreign corporation's income from the insurance of all risks outside the insurer's country of incorporation, whether those risks are located in the United States or in another foreign country. Furthermore, Congress was concerned that the exception tended to permit a large controlled foreign corporation to avoid subpart F treatment of income of an otherwise-tainted kind that was quite substantial in absolute terms.

Captive insurance income

The related person insurance income of many offshore "captive" insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company's U.S. ownership was relatively dispersed, that is, no more than 25 percent of its voting stock was held by 10-percent U.S. shareholders. Generally, a captive insurance company is considered to be a company organized by one or more persons primarily to provide insurance protection to its owners or persons related to its owners. Congress decided to limit the unintended tax advantages received by U.S. taxpayers that jointly own, with a number of other persons, offshore captive insurers, by adopting a special rule which reduces subpart F's U.S. ownership requirements for current taxation of a foreign corporation's income in the case of certain related person insurance income.

One of the major U.S. tax benefits previously claimed by certain offshore captives was exemption from current taxation under subpart F. In addition, under present and prior law, premiums received from U.S. persons by foreign captives are often exempt from the U.S. excise tax on insurance premiums paid to foreign insurers and reinsurers under U.S. income tax treaties, such as that with Barbados. The Barbados treaty, which generally became effective in 1984, waives the insurance excise tax, notwithstanding that Barbados itself does not tax insurance companies licensed under its 1983 Exempt Insurance Act. Thus, income earned by Barbados-based captives with relatively dispersed U.S. ownership could escape current tax anywhere in the world under prior law.[2]

Another tax advantage of offshore captive insurance arrangements is that premiums paid by U.S. taxpayers to offshore captives with even a relatively small number of unrelated owners have been ruled currently deductible in some instances, while, under prior law, current tax was sometimes not imposed on that premium income in the hands of the captive. While captive insurance arrangements are essentially self-insurance arrangements, contributions to which are not deductible,[3] in Rev. Rul. 78-338 (1978-2 C.B. 107), the IRS ruled that amounts paid by a domestic petroleum corporation to a foreign insurance company that provided insurance against certain petroleum industry risks only for its 31 unrelated shareholders and their subsidiaries and affiliates were deductible as insurance premiums. In addition to the fact that the 31 shareholders/insureds of the insurance company were unrelated, the ruling indicated that no one owned a controlling interest and no one's risk coverage could exceed 5 percent of the total risks insured. The ruling concluded that such an arrangement allowed the economic risk of loss to be shifted and distributed among the shareholders who comprised the insured group so that it constituted insurance.

Congress did not believe that U.S. persons utilizing offshore captive insurance companies should be able to avoid current U.S. tax on the related person insurance income of these companies simply by spreading the ownership among a number of persons. Accordingly, the Act provides that tax haven insurance income (as that category of income is expanded by the Act) that is related person insurance income generally is taxable currently under subpart F to an expanded category of U.S. persons.

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[2] The unratified U.S. income tax treaty with Bermuda (signed on July 11, 1986) also waives the insurance excise tax, notwithstanding the absence of any Bermuda income tax. Were the Bermuda treaty to be ratified, captives in Bermuda with relatively dispersed U.S. ownership could escape all current tax also, in the absence of the Act. In a letter to the Secretary of the Treasury, dated July 15, 1986, the Chairman of the Ways and Means Committee expressed "serious concerns about both the substance and the procedures followed by the Treasury Department in negotiating this proposed tax treaty." The letter states that the "proposed treaty, rather than preventing double taxation of income, seems to guarantee that significant sums of income will escape any taxation in either jurisdiction . . . The proposal would bless U.S.-owned Bermuda insurance companies, which, in some cases, through the use of spread captive devices, now may be avoiding all tax other than the excise tax on income earned by insuring U.S. risks. In addition, the U.S. premium payors may be deducting the premiums from U.S. taxable income. Thus, the proposed treaty, by exempting these insurance premiums from U.S. tax, would eliminate not double taxation but any taxation."

[3] In Rev. Rul. 77-316 (1977-2 C.B. 53), the IRS ruled that the amounts described as premiums paid by a domestic corporation and its domestic subsidiaries to the parent's wholly owned foreign subsidiary are not deductible premiums if the subsidiary does not also insure risks of insureds outside its own corporate family. The IRS concluded that because the insured and the "insurance" subsidiary (though separate corporate entities) represent one economic family, those who bear the ultimate economic burden of the loss are the same persons who suffer the loss. Thus, the required risk-shifting and risk-distribution of a valid insurance transaction are missing. This position of the IRS was favorably cited by the Ninth Circuit in *Carnation Co.* v. *United States*, 640 F.2d 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965. In the recent cases of *Humana, Inc. and Subsidiaries* v. *Commissioner*, 50 T.C.M. 784 (1985) and *Mobil Oil Corp.* v. *United States*, 8 Ct. Cl. 555 (1985), the courts have advanced a more developed theory and indicated that the primary criterion in distinguishing a self-insurance arrangement from a true insurance arrangement is the absence of risk-shifting. So long as a wholly owned subsidiary of the taxpayer bears the taxpayer's risk of loss, there has not been sufficient risk-shifting to constitute true insurance, premium payments for which could be deductible.

Shipping income

Foreign base company income subject to current taxation under subpart F did not, under prior law, include foreign base company shipping income that was reinvested in foreign base company shipping operations. Congress did not believe that this reinvestment exclusion was appropriate as a matter of tax policy. Nowhere else in subpart F is such an exception granted; in all other cases, if tainted income is earned through a controlled foreign corporation, then current taxation under subpart F results, regardless of the use to which the income is put. Congress previously made a judgment that shipping income is the type of income rarely subjected to foreign tax that ought to be subject to subpart F when earned through a foreign corporation. Congress decided that as a matter of tax policy that judgment should be given full effect. Because shipping income is seldom taxed by foreign countries, earning such income through a foreign corporation could effectively exempt it from all current tax, U.S. and foreign. The prior exclusion thus served to promote U.S. investment in foreign-flag shipping operations by providing U.S. tax benefits to such investment. Congress questioned whether it was fully in the interests of the United States to promote U.S. investment in the shipping activities of other nations.

Congress was also concerned that income earned in locations outside the jurisdiction of any country could, like shipping income, escape being currently taxed by any country. Examples of such income include income earned in space and on the ocean floor. Congress did not believe that U.S. persons should be able to defer all tax on such income for an indefinite period by earning it through a foreign corporation.

Exception for foreign corporations not used to reduce taxes

As indicated above, income that would have otherwise been subject to current taxation as foreign base company income could be excluded from subpart F under prior law, if the taxpayer established that reducing taxes was not a significant purpose of earning the income through a controlled foreign corporation. The regulations implementing this rule provided an objective test that could be used to determine whether a controlled foreign corporation was used to reduce tax. Congress believed that such an objective test was preferable to the general subjective test previously provided in the statute. An objective test provides greater certainty for both taxpayers and the IRS. Congress believed that "significant purpose" tests tended to involve taxpayers and the IRS in prolonged disputes and litigation, since the correct result under such a rule is often difficult to determine. Although in some cases such an approach cannot be avoided, Congress believed that if movable types of income have been moved to a jurisdiction where they in fact bear a low rate of tax when compared to the U.S. rate, then it is appropriate to impose current U.S. tax on such income without any inquiry into the subjective motivations of the taxpayer. Thus, taxpayers should be permitted to except income from current taxation under subpart F only by showing that such income is subject to foreign tax at a rate substantially equal to the U.S. rate.

Congress was aware that with respect to foreign base company sales and services income the regulations contained a rule that compared the tax paid in the controlled foreign corporation's country of incorporation with the lesser of the U.S. tax or the tax of the country in which such base company income was actually earned. Congress believed that such an approach added substantial complexity and that its retention would have defeated the effort to provide certainty. The rule that looked to the rate of tax in the country of ultimate use of goods or services required the determination of a hypothetical tax on a hypothetical tax base in that country. Thus, taxpayers (and the IRS) were required not only to apply a third country's tax laws, but to do so on the basis of a hypothetical set of tax attributes (income, deductions, basis of assets, etc.) of a business in that country. Congress believed that application of such a rule on a broad scale would create severe enforcement difficulties, since the IRS would be required to make the above determinations with respect to a large number of taxpayers claiming the benefits of such a rule. Furthermore, certain of the rules of subpart F represent judgments that certain types of income are particularly prone to manipulation, and that earning such income through a foreign corporation is by itself enough to justify a presumption that the potential for tax avoidance is too great to permit continued deferral of U.S. tax. Congress did not believe that the presence or absence of tax advantages in the foreign country of incorporation relative to that where income is earned was relevant to the validity of those judgments relating to avoidance of U.S. taxes; it believed that otherwise-applicable subpart F rules should generally apply regardless of relative foreign country tax considerations. Therefore, Congress concluded that it was appropriate to eliminate any comparison with a hypothetical rate of tax in the country of ultimate use, and to rely instead on a comparison with the U.S. rate of tax in all cases.

Deficits

For several reasons, Congress decided to restrict the use of deficits to reduce subpart F income. First, as discussed in greater detail at A.2., above, Congress sought to simplify the operation of the separate limitation look-through rules for controlled foreign corporations by conforming them and the subpart F rules to the extent feasible. Congress did not believe that separate limitation income received by controlled foreign corporations should be eliminated for foreign tax credit limitation purposes by deficits of other controlled foreign corporations, or prior year deficits in other income categories. Congress did not believe, either, that separate limitation income of controlled foreign corporations should be permanently eliminated by current year deficits in other income categories. Preserving such separate limitation income for foreign tax credit limitation purposes without a corresponding preservation of such income for subpart F purposes would have substantially complicated the application and administration of the look-through rules.

This is particularly the case with respect to the separate limitations for passive and shipping income since passive income and shipping income are defined for separate limitation purposes by reference to the subpart F categories of foreign personal holding company income and foreign base company shipping income, respectively.

Second, Congress believed that the prior law deficit rules allowed U.S. taxpayers operating abroad through controlled foreign corporations to shelter too much tax haven income from current U.S. tax. Under the chain deficit rule of old section 952(d) (as interpreted under regulations), a loss incurred anywhere in a chain of controlled foreign corporations eliminated U.S. tax on an equal amount of income earned elsewhere in the chain even though the loss might have been in a nonsubpart F income category or borne little or no relation to the income it offset.

Similarly, the accumulated deficit rule of old section 952(c) allowed a controlled foreign corporation to avoid tax on subpart F income by offsetting that income with prior year deficits it incurred in nonsubpart F or unrelated income categories. Had this rule not been modified, taxpayers could in many cases have sheltered from U.S. tax income from passive investments by moving those investments into controlled foreign corporations with prior year deficits.

Congress noted that even deficits in earnings and profits incurred by foreign corporations before their acquisition by a U.S. corporation could be used to shelter post-acquisition subpart F income of the U.S. corporation from tax under prior law, unless the IRS could show (under sec. 269) that the acquisition was made to evade or avoid income tax. Loss trafficking with respect to foreign corporations was not restricted by any rule corresponding to the special anti-loss trafficking rule (sec. 382) applicable to U.S. corporations. The Act's repeal of the chain deficit rule and modifications to the accumulated deficit rule limit the use of acquired deficits.

A third factor in Congress' decision to repeal the chain deficit rule was its inconsistency with the present and prior law rule requiring recognition of gain upon the incorporation of a foreign loss branch (sec. 367(a)(3)(C)). That rule effectively prevents taxpayers that reduce their worldwide income by using losses incurred by a foreign branch from deferring U.S. tax on the foreign enterprise's subsequent profits while incorporating it tax-free when it turns profitable. Similar current utilization of losses, followed by deferral of tax on income, could be achieved under prior law, however, using controlled foreign corporations, as a result of the chain deficit rule.

Another problem with the chain deficit rule that was brought to Congress' attention was the ability that the provision conferred upon some taxpayers effectively to utilize the same deficits twice. Assume, for example, that a U.S. corporation controlled two foreign corporations. One of these foreign corporations owned the other. One of the foreign corporations (the "loss corporation") had a current deficit in earnings and profits of $100. To fund that deficit, the U.S. corporation made an additional $100 contribution to the loss corporation's capital. That capital contribution increased by $100 the U.S. corporation's basis in its stock in the loss corporation. Under the chain deficit rule, the $100 deficit reduced the second controlled foreign corporation's currently taxable subpart F income in the year in which the deficit arose. In the following year, the U.S. corporation's stock in the loss corporation became worthless. Under the present and prior law rules governing the deduction of losses for worthless securities (sec. 165(g)), that stock was a capital asset and the U.S. corporation could therefore deduct in full its basis in the stock, including the $100 component of that basis corresponding to the prior year's additional capital contribution. The loss corporation's $100 deficit in earnings and profits thus reduced the U.S. corporation's taxable income twice, once in the first year under the chain deficit rule, and then again in the following year under the rule allowing a loss deduction for worthless securities. A similar result could be achieved when debt was used to fund a controlled foreign corporation's loss and was later written off.

Explanation of Provisions

Overview

The Act generally narrows the exceptions to subpart F income and adds to it certain other types of income that are particularly susceptible of manipulation. Thus, net gains on sales of property which does not generate active income, net commodities gains, and net foreign currency exchange rate gains are added to subpart F foreign personal holding company income. The general exception from subpart F foreign personal holding company income for certain payments between related persons is subjected to a new look-through rule that takes into account the subpart F income of related party payors. In addition, the Act generally repeals the exceptions from subpart F foreign personal holding company income for banking and insurance companies' income from interest, dividends, and dispositions of stock and securities.

The reinvestment exclusion for shipping income is repealed, and the scope of the insurance income subject to subpart F is broadened under the Act. Among the types of insurance income subjected to current tax by the Act is related person insurance income of captive insurers. The Act also repeals the chain deficit rule and imposes other restrictions on the use of deficits by controlled foreign corporations.

Congress recognized that broadening the scope of current U.S. taxation under subpart F might in some cases affect the operations of U.S. taxpayers using foreign corporations for business rather than tax reasons. To minimize any such effect, Congress placed increased reliance on the provision of subpart F that excepts income from current taxation if it was not in fact routed through a controlled foreign corporation in which it bore a lower tax than would be due if earned by a U.S. corporation. To that end, the Act replaces the subjective "significant purpose" test of prior law with an objective test to determine whether income that has been earned through a controlled foreign corporation has in fact been subject to less tax than it would have borne if earned directly.

Sales of property which does not generate active income

The Act adds to the Code section 954(c) definition of foreign personal holding company income for subpart F purposes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to the following types of income: first, dividends and interest; second, rents and royalties other than active business, unrelated party rents and royalties; and, third, annuities. Thus, included in foreign personal holding company income is, for example, gain on the sale of diamonds held for investment purposes prior to disposition. As another example, gain from the disposition of a patent that gave rise to unrelated party, active business royalties is not treated as foreign personal holding company income under this rule while gain from the sale of a patent licensed to a person related to the seller is so treated. As under prior law, stock and securities gains are foreign personal holding company income under the Act.

The Act retains the exception from the current taxation rules for securities gains of regular dealers and extends that exception to the broader category of gains just described. Thus, for example, the gain of a regular art dealer on the sale of a painting does not constitute subpart F foreign personal holding company income. On the other hand, the gain of a company on the sale of a painting held as investment property generally is subpart F foreign personal holding company income (at least before application of subpart F's de minimis exception): if, prior to its disposition, the painting merely was displayed in the corporate offices or held in storage, it would not have given rise to any income; if, prior to its disposition, the painting was leased temporarily by the corporation for compensation, such compensation would presumably not have been active rental income of the type excluded from foreign personal holding company income. Gains from the sale or exchange of other property which, in the hands of the seller, is inventory property (sec. 1221(1)) are excluded from the application of the new rule.

The Act retains the prior law subpart F treatment of gains on sales of stock and securities. Thus, gain on the sale of stock in, for example, a foreign corporation, whether or not created or organized in the same foreign country as the selling company, constitutes foreign personal holding company income under subpart F.

Congress intended that income from commodity and currency transactions that are within the scope of the special subpart F provisions for such transactions (discussed immediately below) not be subject to tax under this provision. Thus, for example, a transaction that would be subject to tax under the special rule for commodities transactions but for the active producers' exception to that rule is not subject to tax under this provision.

The provision also is not intended to apply to gain on the sale of land, buildings, or equipment used by the seller in an active trade or business of the seller at the time of the sale.

Commodities transactions

The Act adds to the section 954(c) definition of foreign personal holding company income for subpart F purposes the excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodities.

The Act retains prior law's subpart F exception for gains by a producer, processor, merchant, or handler of a commodity which arise from bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

An additional exception is provided for transactions (not limited to hedging transactions) that occur in the active business of a foreign corporation substantially all of whose business is that of an active producer, processor, merchant, or handler of commodities. Congress intended this exception to apply only to foreign corporations actively engaged in commodities businesses, not those primarily engaged in such financial transactions as the trading of futures. Regularly taking delivery of physical commodities will generally indicate the existence of such a business, but such activity will not of itself determine the issue. For example, the business of a company that trades primarily in precious metals may be essentially financial, particularly if the company takes delivery of the metals through an agent such as a bank. (The availability, if any, of the hedging exception discussed in the preceding paragraph with respect to such a business is not affected by the Act.)

Other characteristics of companies actively engaged in commodities businesses include: engaging in substantial processing activities and incurring substantial expenses with respect to commodities prior to their sale, including (but not limited to) concentrating, refining, mixing, crushing, aerating, and milling; engaging in significant activities and incurring substantial expenses relating to the physical movement, handling, and storage of commodities, including (but not limited to) preparation of contracts and invoices, arrangement of freight, insurance, or credit, arrangement for receipt, transfer, or negotiation of shipping documents, arrangement of storage or warehousing, and dealing with quality claims; owning and operating physical facilities used in the activities just described; owning or chartering vessels or vehicles for the transportation of commodities; and producing the commodities sold. Active business gains and losses from commodity sales include gains and losses from financial transactions which constitute bona fide hedging transactions integrally related to a principal business of trading in physical commodities.

Income from foreign currency transactions that are not section 988 transactions (for example, a position marked to market under section 1256) may be subject to current taxation under this provision. Foreign currency gains attributable to section 988 transactions, however, are to be treated exclusively under the special subpart F provision dealing with foreign currency gains (discussed immediately below). Accordingly, the applicability to foreign currency gains attributable to section 988 transactions of the business needs exception of that special subpart F provision is not restricted in any manner by the subpart F rule on commodities transactions.

No inference was intended as to the types of commodity transactions that, under prior law, might be considered futures transactions in a commodity on or subject to the rules of a board of trade or commodity exchange.

Foreign currency gains

The Act adds to the section 954(c) definition of foreign personal holding company income for subpart F purposes the excess of foreign currency gains over foreign currency losses attributable to section 988 transactions. Foreign currency gains and losses attributable to section 988 transactions are defined as they are for purposes of the Act's new rules relating to the taxation of foreign currency exchange rate gains and losses (sec. 1261 of the Act; *see* F., below).

An exception to current taxation under this provision is provided for hedging and other transactions that are directly related to the business needs of a controlled foreign corporation. For example, active foreign currency gains and losses arising from a controlled foreign corporation's business as an active foreign currency dealer are excluded from subpart F foreign personal holding company income. In addition, foreign currency gains arising from hedging its inventory would generally be directly related to the business needs of the controlled foreign corporation but foreign currency gains arising from hedging a related person's inventory or other assets of that related person would not be directly related to the business needs of the controlled foreign corporation.

Dividends, interest, and securities gains of banking and insurance businesses

The Act generally imposes current tax on foreign personal holding company income earned by banks and insurance companies, subject to the exclusion for high-taxed income described below. The Act does so by repealing the rules that previously excluded from foreign personal holding company income for subpart F purposes dividends, interest, and gains from the sale or exchange of stock or securities received from unrelated persons either in the active conduct of a banking, financing, or similar business, or from an insurance company's investment of unearned premiums, reserves, and certain other funds (old section 954(c)(3)(B) and (C)). Thus, dividends, interest, and gains received from unrelated persons by a controlled foreign bank or insurance company generally constitute foreign personal holding company income taxable currently to the U.S. shareholders of the corporation. The Act also repeals the rule that previously excluded from foreign personal holding company income for subpart F purposes interest paid by a related person to a controlled foreign corporation if both were engaged in a banking, financing or similar business (old section 954(c)(4)(B)).

The Act preserves tax deferral, however, to the limited extent available under prior law, for interest derived in a banking business in connection with certain export sales. To qualify for this export financing exception, interest must be derived in the conduct of a banking business from financing the sale (or other disposition) for use or consumption outside the United States of property which is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For this purpose, the fair market value of any property imported into the United States is its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. A related person is defined for this purpose in the same manner as it is defined generally for subpart F purposes (Code sec. 954(d)(3) as amended by the Act; *see* discussion of related person definition at C.2.b., below).

The export financing exception provides relief from the Act's expansion of the subpart F rules; it does not liberalize prior law's subpart F rules. Thus, the export financing exception does not apply to interest that was subpart F foreign personal holding company income prior to the 1986 Act under the factoring rules of the Tax Reform Act of 1984 (*see* Code sec. 864(d)). Under the 1984 Act's factoring rules, any income of a controlled foreign corporation from a loan to a person for the purpose of financing the purchase of inventory property of a related person is interest for subpart F purposes without regard to the exceptions to prior law's subpart F rules; thus, under the 1986 Act, such income of controlled foreign corporations is not eligible for the export financing exception to the subpart F rules either. Consistent with prior law, the export financing exception to the subpart F rules applies primarily to otherwise eligible interest that is derived from financing the sale of noninventory property.

Income received by an offshore insurance company, including income derived from its investments of funds, generally is subject to taxation under Code section 953, as amended by the Act (see discussion at "*Insurance income in general,*" below). Regulations under prior law specify that taxation of an insurance company's income under section 953 takes precedence over taxation of that income as foreign personal holding company income under section 954 (Treas. Reg. sec. 1.953-6). When dividends, interest, or securities gains derived by a controlled foreign insurance company are not taxed under section 953, they are taxed as foreign personal holding company income under section 954 unless they are exempt from section 954 tax under the substantial foreign tax exception (discussed below under "*Exception for foreign corporations not used to reduce taxes*"), a related person exception (discussed below), or the de minimis exception (discussed at C., below).

Income equivalent to interest

The Act treats income equivalent to interest as foreign personal holding company income for subpart F purposes. For this purpose, income equivalent to interest includes, for example, commitment fees for the actual lending of money.

Passive leasing income

The Act retains the prior law exclusion from subpart F foreign personal holding company income for rents and royalties received in the active conduct of a trade or business from unrelated persons. The Act clarifies that passive leasing income, like other rent and royalty income not received in the active conduct of a trade or business, generally is subpart F foreign personal holding company income.

Related person exceptions

The Act restricts the rule that excludes from foreign personal holding company income for subpart F purposes certain dividends, interest, rents, and royalties received from related persons (new sec. 954(c)(3)). Under the new restriction, interest, rent, and royalty payments do not qualify for the exclusion to the extent that such payments reduce subpart F income of the payor. Thus, if the income of the payor corporation consists entirely of nonsubpart F income, then the related party exclusions apply in full as under prior law. However, to the extent that the payor corporation receives subpart F income which is reduced by its payment of interest, rent, or royalties, then such payment is treated as subpart F income to a related party recipient, notwithstanding the general rules of new section 954(c)(3).

Old section 954(c)(4)(B), relating to interest paid between related banks, is repealed by the Act. (*See* discussion of dividends, interest, and securities gains of banking and insurance businesses, above.)

The Act also provides a limited, five-year exclusion from subpart F foreign personal holding company income for certain mining-related income.

Insurance income in general

The Act expands the section 953 definition of tax haven insurance income that is subject to current taxation under subpart F. Subpart F applies under the Act to any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than that in which the insurer is created or organized. In addition, subpart F applies to income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of premiums for insurance of other-country risks. The amount of income subject to tax under subpart F is the amount that would be taxed under subchapter L of the Code if it were the income of a domestic insurance company (subject to the modifications provided in section 953(b)).

The Act repeals the de minimis rule of old section 953(a), which excluded income from the insurance of U.S. risks that was otherwise subject to subpart F if it constituted 5 percent or less of the total premium-type income of an insurance company. Thus, in general, any income of a controlled foreign corporation from the insurance of risks located in other countries is subject to current taxation under subpart F, in accordance with the provisions of subchapter L (as modified). However, the Act does make all tax haven insurance income eligible for the general subpart F de minimis exception and, except for income earned by a company that is a controlled foreign corporation only for purposes of the captive insurance company provision (new Code sec. 953(c)), the 70-percent full inclusion rule (sec. 954(b)(3), as amended by the Act; discussed at C.2.c., below).

The special definition of a controlled foreign corporation provided in section 957(b) for purposes of taking into account insurance income described in section 953(a) continues to apply with respect to section 953 as amended by the Act. Under the special definition, a foreign corporation is considered a controlled foreign corporation if more than 25 percent of the corporation by vote or value is owned by U.S. shareholders.

Captive insurance income

The Act further provides that tax haven insurance income (as that category of income is expanded by the Act) that is related person insurance income generally is taxable currently under subpart F to an expanded category of U.S. persons. For purposes of taking into account such income under subpart F, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person (as defined for subpart F purposes by new section 957(c)) who owns or is considered to own (under the rules of section 958(a)) any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income.

Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (as defined above) in the foreign corporation receiving the income or a person related to such a shareholder. A related person is defined for this purpose in the same manner as it is for subpart F purposes generally (sec. 954(d)(3), as amended by the Act). The new rule for captive insurers applies to investment income as well as to premium income attributable to related person insurance. Whether investment income is attributable to related person insurance is to be determined on an annual basis under rules analogous to those set forth in Treasury regulations governing the apportionment under prior law of investment yield and net-long term capital gain to the insurance of U.S. risks (Treas. Reg. sec. 1.953-4(f)(2)&(3)). If, in 1987, for example, a captive insurer's premium income is attributable partly or entirely to related person insurance, then the investment income that it receives in 1987 is partly related person insurance income or entirely related person insurance income, respectively.

Related person insurance income includes income attributable to policies of reinsurance issued by a foreign corporation to U.S. shareholders of that corporation (as defined above) that previously insured the risks covered by such policies or to persons related to such shareholders that previously insured the risks covered by such policies. Related person insurance income also includes income attributable to officers' or directors' insurance where the U.S. shareholders of the foreign corporation receiving such income (or persons related to such shareholders) directly or indirectly pay the premiums and the insureds are officers or directors of the U.S. shareholders (or persons related to such shareholders). The special rules for computing tax haven insurance income provided by section 953(b) (unchanged by the Act) apply in computing related person insurance income.[4]

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[4] A technical correction may be needed so that the statute reflects this intent.

The Act provides three exceptions to the new subpart F rules for captive insurers. First, related person insurance income of a captive insurer is not currently taxable by reason of the new rules if the corporation's gross related person insurance income for the taxable year is less than 20 percent of its gross insurance income for the year. Insurance income is defined for this purpose as it is generally for subpart F purposes under the Act, except that the exclusion of income attributable to same-country risks does not apply. The purpose of this rule is to except from the operation of the provision foreign insurance companies with 25-percent or more U.S. ownership that do not earn a significant proportion of related person insurance income.

Second, related person insurance income of a captive insurer is not currently taxable under the new provision if less than 20 percent of the total combined voting power of all classes of stock of the corporation entitled to vote and less than 20 percent of the total value (both stock and policies) of the corporation during the taxable year are owned (directly or indirectly) by persons who are the primary insureds under any policies of insurance or reinsurance issued by the corporation, or by persons related to such persons. A related person is defined for this purpose in the same manner as it is for subpart F purposes generally (sec. 954(d)(3), as amended by the Act). This exception serves a purpose similar to that served by the exception for companies with de minimis amounts of related person insurance income.

Third, the Act provides that a corporation which is a controlled foreign corporation solely by virtue of the new rules for captive insurers may elect to treat related person insurance income that would not otherwise be taxed as income effectively connected with the conduct of a U.S. trade or business, taxable under section 882, as income that is effectively connected with a U.S. trade or business. The income deemed to be effectively connected under this election will be excluded from subpart F income. The election is to be made at such time and in such manner as the Secretary may prescribe. The election is effective in the year made and in all future years. It is revocable only with the Secretary's consent. To make such an election, the foreign corporation must waive all U.S. treaty benefits with respect to its related person insurance income. The election is not effective if the electing corporation fails to meet such requirements as the Secretary shall prescribe to ensure that the tax imposed on its related person insurance income is paid. Any tax imposed on an electing corporation's related person insurance income may, if not paid by that corporation, be collected from the corporation's U.S. shareholders.

Electing offshore captives continue to be taxed currently on their related person insurance income, since effectively connected income is taxed currently. However, the election generally allows them to receive the same tax benefits as similarly situated U.S. insurers with respect to related person insurance activity. Thus, electing offshore captives that incur net operating losses from meeting large claims will be able to carry those losses back 3 years and forward 15 years under the net operating loss carryover rules (sec. 172). The availability of loss carryovers may be of particular benefit to insurers of those risks with respect to which the tax law may not permit deductions for reserves. Congress adopted the election primarily with such foreign insurers in mind. Income treated as effectively connected under the election is considered effectively connected for purposes of the Code rule providing a deduction for certain dividends received by 10-percent U.S. owners of foreign corporations (sec. 245).

The new subpart F rules for captive insurers apply to both stock and mutual insurance companies. For this purpose, the policyholders of a mutual insurance company are treated as its shareholders. The rules are to be adapted in appropriate respects for application to mutual companies, under regulations.

Congress recognized that foreign mutual insurance companies that insure a significant number of U.S. persons may technically have significant amounts of related person insurance income (as defined for purposes of the Act) solely because such companies are owned by their policyholders. However, Congress understood that, in the typical non-captive case, such income derived by the insurance company is effectively connected with the conduct of a U.S. trade or business and, consequently, under present and prior law, is taxed by the United States; the reason is that most foreign mutuals with a significant number of U.S. policyholders have permanent establishments in the United States. Under present and prior Code rules, subpart F income does not include U.S. source income that lacks treaty protection from U.S. tax and is effectively connected with the conduct of a U.S. trade or business (sec. 952(b)). Therefore, so long as they continue to do business in the United States through permanent establishments, it is anticipated that the income of these foreign mutual companies attributable to U.S. insureds generally will not be taxed under the new subpart F provision for captive insurers.

Premiums received by a captive insurer that is subject to the new subpart F rules, like premiums received by an offshore insurer that is subject to present law subpart F, generally remain subject to the excise tax on insurance premiums paid to foreign insurers, absent a treaty exemption. However, the excise tax does not apply to income treated as effectively connected with the conduct of a U.S. business under the "effectively connected" election. This is consistent with the present and prior law exemption from the excise tax generally accorded to premiums that are effectively connected with the conduct of a U.S. business.

The Act requires the Secretary to prescribe such regulations as may be necessary to carry out the purposes of the new subpart F rules for captive insurers, including regulations preventing the avoidance of the new rules through cross-insurance arrangements or otherwise. Assume, for example, that a foreign company is owned by 35 U.S. persons unrelated to one another but engaged in similar businesses. The company's primary business is insuring against certain risks of those U.S. persons. Under the Act, it generally has related person insurance income in profitable years, taxable currently to its U.S. owners.

Assume, however, that the captive insurance arrangement is modified as follows: The foreign company is liquidated and two new foreign companies are organized. One of the companies is owned by 18 of the U.S. persons that formerly owned the liquidated company.

The other new company is owned by the other 17 persons that formerly owned the liquidated company. The primary business of the first company is insuring against certain risks of the 17 owners of the second company. The primary business of the second company is insuring against certain risks of the 18 owners of the first company.

Congress believed that such an arrangement is essentially equivalent to a captive insurance arrangement. It can be used to achieve a similar degree of cooperative risk-sharing among similarly situated members of an industry. Congress did not believe that U.S. shareholders should be able to obtain the deferral of U.S. tax on income attributable to insurance of risks of U.S. persons who are in turn insuring the risks of those shareholders. Accordingly, under the regulations, the income of the two companies in the example attributable to the insurance business described is to be treated as related person insurance income. The existence of a single foreign entity subject to the general subpart F rules for captives prior to the creation of such a cross-insurance arrangement is not necessary to support a finding that such an arrangement was made or availed of to avoid the captive insurer rules.

Shipping income

The Act repeals the rule that, under prior law, excluded from foreign personal holding company income for subpart F purposes foreign base company shipping income that was reinvested in foreign base company shipping operations (old section 954(b)(2)). Thus, any income that constitutes foreign base company shipping income under section 954(f) is now subject to current taxation under subpart F, regardless of the controlled foreign corporation's use of the income. In addition, the Act adds to the definition of foreign base company shipping income any income derived from activities outside the jurisdiction of any country, including generally income derived in space, in the ocean, or in Antarctica, that is subject to the Act's new sourcing rule for income from space and certain ocean activities (*see* new sec. 863(d), discussed at B.3., above). The amendments to the foreign base company shipping provisions were not intended to modify the taxation of withdrawals of previously excluded subpart F income from qualified shipping reinvestments.[5]

Exception for foreign corporations not used to reduce taxes

The Act modifies the rule of section 954(b)(4), which excludes non-tax avoidance income from current taxation under subpart F, by replacing prior law's subjective "significant purpose" test with an objective rule. Under the new rule, subpart F income does not include items of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that the income, measured under U.S. tax rules, was subject to an effective rate of foreign tax equal to at least 90 percent of the maximum U.S. corporate tax rate.[6] However, this exception to subpart

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[5] A technical correction may be needed so that the statute reflects this intent.

[6] Under the Act, the maximum corporate tax rate generally is 34 percent. However, income in taxable years that include July 1, 1987 (other than as the first date of such year) is subject to

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F does not apply to foreign base company oil-related income described in section 954(a)(5). Foreign tax, for purposes of this exception, includes deemed-paid foreign tax under section 902 or 960.

Section 954(b)(4), as amended by the Act, was intended to apply solely at the taxpayer's election. That is, the provision applies only if the taxpayer endeavors to establish to the Secretary's satisfaction that the income in question was subject to the requisite foreign tax, and the taxpayer succeeds in doing so. The Secretary may not apply the provision without the taxpayer's consent.

Although section 954(b)(4) applies separately with respect to each "item of income" received by a controlled foreign corporation, Congress indicated that it expected that the Secretary would provide rules permitting reasonable groupings of items of income that bear substantially equal effective rates of tax in a given country. For example, all interest income received by a controlled foreign corporation from sources within its country of incorporation may reasonably be treated as a single item of income for purposes of this rule, if such interest is subject to uniform taxing rules in that country.

Congress intended, by making the operation of this rule more certain, to ensure that it could be used more easily than the subjective test of prior law could be. This is important because it lends flexibility to Congress' general broadening of the categories of income that are subject in the first instance to current tax under subpart F. Congress' judgement was that because movable income could often be as easily earned through a U.S. corporation as a foreign corporation, a U.S. taxpayer's use of a foreign corporation to earn that income may be motivated primarily by tax considerations. If, however, in a particular case no U.S. tax advantage is gained by routing income through a foreign corporation, then the basic premise of subpart F taxation is not met, and there is little reason to impose current tax under subpart F. Thus, since the scope of transactions subject to subpart F is broadened under the Act and may sweep in a greater number of non-tax motivated transactions, Congress expected that the flexibility provided by a readily applicable exception for such transactions would become a substantially more important element of the subpart F system.

Deficits

The Act repeals the chain deficit rule (old sec. 952(d)). Thus, U.S. shareholders of one controlled foreign corporation cannot benefit from deficits of another controlled foreign corporation except in limited circumstances, described below, involving mergers of commonly owned controlled foreign corporations.

The Act also limits the rule (the "accumulated deficit rule") permitting a controlled foreign corporation to reduce subpart F income by the sum of its prior year deficits in earnings and profits (sec. 952(c)). Subject to the conditions described below, the Act provides that foreign base company shipping income, foreign base company oil related income, subpart F insurance income, or foreign personal holding company income of a controlled foreign corpora-

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blended rates under the rules specified in Code section 15. For purposes of section 954(b)(4), the maximum tax rate for such income is the maximum blended rate specified in section 15 for the taxpayer. A technical correction may be needed so that the statute reflects this intent.

tion may be reduced by accumulated deficits in that corporation's earnings and profits attributable to activities that give rise to foreign base company shipping income, foreign base company oil related income, subpart F insurance income, or foreign personal holding company income, respectively. Other categories of subpart F income may not be reduced by accumulated deficits under the Act. Subpart F insurance income may be reduced under the rule just described only if the controlled foreign corporation receiving such income was predominantly engaged in the active conduct of an insurance business (within the meaning of new sec. 904(d)(2)(C)(ii), discussed at A.2., above) in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. Foreign personal holding company income may be reduced under this new rule only if the controlled foreign corporation receiving such income was predominantly engaged in the active conduct of a banking, financing, or similar business (within the meaning of new sec. 904(d)(2)(C)(ii)) in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. Accumulated deficits may be used only once. To be eligible for use under the rule, an accumulated deficit must arise in a year for which the foreign corporation incurring such deficit is a controlled foreign corporation. As under prior law, accumulated deficits that cannot be utilized in one year may be carried over indefinitely for possible use in later years. Under the accumulated deficit rule, as modified, accumulated deficits for taxable years beginning before 1987 may not be carried forward to reduce subpart F income.

A U.S. shareholder in a controlled foreign corporation may reduce its subpart F inclusion with respect to that corporation only by the shareholder's pro rata share of accumulated deficits. A U.S. shareholder's pro rata share of any accumulated deficit is to be determined under rules similar to the present and prior law rules which limit subpart F inclusions to a shareholder's pro rata share of subpart F income (sec. 951(a)(2)), for whichever of the following yields the smaller share: the close of the current taxable year or the close of the year in which the deficit arose. Under this rule, then, accumulated deficit use is limited by the size of a U.S. shareholder's interest in a controlled foreign corporation in the current year and in the year in which the deficit was incurred. Under present and prior law, subpart F and section 1248 inclusions are similarly limited by the size of a shareholder's interest in the controlled foreign corporation when the relevant earnings and profits arose.

Under the Act, then, pre-acquisition deficits of an acquired corporation to which a controlled foreign corporation in the acquiring group succeeds may not reduce post-acquisition subpart F income of the controlled foreign corporation's shareholders (except to the extent that such shareholders had ownership interests in the acquired corporation when the deficits arose and the acquired corporation was a controlled foreign corporation then). Similarly, premerger deficits of a foreign corporation merged into a controlled foreign corporation may not reduce post-merger subpart F income of the controlled foreign corporation's shareholders (except to the extent that such shareholders had ownership interests in the merged corporation when the deficits arose and the merged corporation was a controlled foreign corporation then). Congress indicated that it expected the Secretary to issue regulations implementing the above rules, including regulations limiting the use of deficits in connection with other reorganizations.

The Act retains the prior law rule permitting current deficits in earnings and profits in any income category, including nonsubpart F income categories, to reduce subpart F income for the year (sec. 952(c)). However, if subpart F income of a foreign corporation is reduced by reason of this rule, the Act provides that any excess of the earnings and profits of that corporation over its subpart F income in any subsequent taxable year is to be recharacterized as subpart F income under rules similar to the Act's separate limitation loss recharacterization rule (*see* A.4., above) and, thus, is to be currently included in the income of the corporation's U.S. shareholders in the year of recharacterization.

When this recharacterization provision applies, subpart F-type income that is recaptured for foreign tax credit limitation purposes under the separate limitation loss recharacterization provision is effectively recaptured for subpart F purposes as well. For example, income of a controlled foreign corporation that is passive after application of the separate limitation loss recharacterization provision may also be subpart F foreign personal holding company income currently taxable to the corporation's U.S. shareholders. The subpart F recharacterization provision thus helps to integrate subpart F and the separate foreign tax credit limitation rules. Foreign taxes on income recharacterized under the subpart F recharacterization provision, like foreign taxes on income recharacterized under the separate limitation loss recharacterization provision, are not themselves recharacterized. For example, foreign taxes on nonsubpart F, overall limitation income that is recharacterized as subpart F, separate limitation income in a later year may be credited only against U.S. tax on other nonsubpart F, overall limitation income.

The application of the accumulated deficit rule, as modified by the Act, is illustrated in the following three examples: Assume that a controlled foreign corporation wholly owned by a U.S. corporation incurs a $100 deficit in earnings and profits in a taxable year. Sixty dollars of the deficit is attributable to activities that, when profitable, generate foreign base company shipping income. The other $40 of the deficit is attributable to activities that, when profitable, generate foreign base company oil related income. In the following year, the controlled foreign corporation earns $90 of foreign base company shipping income, $20 of foreign oil related income, and $10 of foreign base company services income. (For simplicity, this example and the two following assume that gross income, net taxable income, and earnings and profits are the same.) Under the Act, the full $60 portion of the accumulated deficit attributable to base company shipping activity can be used to reduce (to $30) the U.S. parent's base company shipping income inclusion with respect to the foreign corporation. Twenty dollars of the $40 portion of the accumulated deficit attributable to base company oil related activity can be used to eliminate the $20 of base company oil related income. The remaining $20 of the accumulated deficit cannot be utilized to reduce the U.S. parent's base company services income or remaining base company shipping income since this deficit amount arose only from base company oil related income, not from base company services or shipping activity. For the year then, the U.S. parent's subpart F income with respect to the foreign corporation after the accumulated deficit is applied consists of $30 of base company shipping income, $10 of base company services income, and no base company oil related income. The $20 portion of the accumulated deficit attributable to foreign oil related activity which is not utilized may be carried over for possible use in characterizing income of the foreign corporation in later years.

Assume, as another example, that a foreign manufacturer wholly owned by a U.S. corporation incurs a $100 deficit in earnings and profits in a taxable year. The manufacturing operations of the controlled foreign corporation, when profitable, generate nonsubpart F income. In the following year, the U.S. parent sells through its foreign subsidiary to third-country buyers goods that a U.S. subsidiary of the U.S. parent produces. With respect to these sales, the foreign corporation receives $30 of foreign base company sales income, currently taxable to its U.S. parent under subpart F. The foreign corporation also earns $80 of nonsubpart F manufacturing income. Because the deficit arose in a prior year in a nonsubpart F category, the amendment to the accumulated deficit rule prevents the $100 accumulated deficit from reducing the current year's subpart F income. For the year then, subpart F income consists of the $30 of foreign base company sales income.

The application of the accumulated deficit rule, as modified, is further illustrated in the following example: Assume that a foreign corporation, wholly owned by a U.S. corporation, incurs a $100 deficit in earnings and profits in a taxable year. The controlled foreign corporation is predominantly engaged in the active conduct of a banking business during that year. When profitable, the foreign corporation earns primarily foreign personal holding company income, as that category of subpart F income is expanded by the Act. The deficit arises from activities that generate foreign personal holding company income. On the first day of the following year, 40 percent of the stock of the controlled foreign corporation is sold to a second U.S. corporation. The foreign corporation earns $300 of foreign personal holding company income and no other income during that taxable year. It is predominantly engaged in the active conduct of a banking business during that year. The second U.S. corporation's share of the subpart F income is $120 (40 percent of $300). The second U.S. corporation cannot reduce its subpart F inclusion by any portion of the $100 accumulated deficit because it owned no stock in the foreign corporation in the preceding year, when the deficit was incurred. The first U.S. corporation can reduce its $180 (60 percent of $300) share of the subpart F income by $60 (60 percent of $100) of the accumulated deficit; under the accumulated deficit rule, as modified, its pro rata share of the deficit is determined for the close of the current year because such determination yields a smaller pro rata share than a determination of such share for the close of the deficit year.

The interaction of the new subpart F recharacterization rule, the subpart F earnings and profits limitation retained by the Act, and the Act's foreign loss allocation and separate limitation loss recharacterization rules is illustrated in the following example: Assume that a foreign corporation wholly owned by a U.S. corporation has a $100 overall limitation loss. It also has $200 of passive (subpart F foreign personal holding company) income before allocation of the loss. Assume, for simplicity, that earnings and profits equal income. Under the foreign loss allocation rule (which parallels the subpart F earnings and profits limitation), the $100 loss reduces the corporation's passive income for the year from $200 to $100. The subpart F earnings and profits limitation also reduces the income currently taxable to the corporation's U.S. shareholders from $200 to $100.

The following year, the corporation earns $250 of passive (subpart F foreign personal holding company) income and $1,500 of overall limitation (nonsubpart F) income. Under the separate limitation loss recharacterization rule, an amount of this overall limitation income equal to the prior year overall limitation loss that reduced passive income, $100, is recharacterized as passive income. Thus, for foreign tax credit limitation purposes, the corporation has $1,400 ($1,500 − $100) of overall limitation income and $350 ($250 + $100) of passive income in the second year. Under the subpart F recharacterization rule, the recaptured $100 of passive income is also subpart F foreign personal holding company income since subpart F foreign personal holding company income the year before was reduced by $100 under the earnings and profits limitation and, in the current year, earnings and profits exceed tentative subpart F income by at least that amount. Thus, the subpart F inclusion of the corporation's shareholders is $350 ($250 + $100) in the second year. Any foreign taxes imposed on the $100 of originally overall limitation, nonsubpart F income that is recharacterized as passive, subpart F income may be credited against other overall limitation, nonsubpart F income only.

Effective Date

In general, the above changes to subpart F apply for taxable years of foreign corporations beginning after December 31, 1986. Targeted transitional rules are provided. Also the limited exclusion from subpart F for certain mining-related income is effective for dividends received by a specified foreign corporation during any of its first 5 taxable years beginning after December 31, 1986.

2. Thresholds for imposition of current tax under subpart F [7]

a. Determination of U.S. control of foreign corporations (sec. 1222 of the Act and secs. 552 and 957 of the Code)

Prior Law

The provisions of subpart F (Code secs. 951-964), which impose current tax on foreign corporate earnings, apply only to controlled foreign corporations (see discussion at C.1., above). Under prior law, a corporation was a controlled foreign corporation only if more than 50 percent of the voting power of the corporation belonged to U.S. persons that each owned at least 10 percent of that voting power. Similarly, the foreign personal holding company rules (Code secs. 551-58), which also impose current U.S. tax on some foreign corporate investment income, applied only if more than 50 percent of the value (as opposed to voting power) of the corporation belonged to five or fewer U.S. individuals.

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[7] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 622, 623, and 624; H.Rep. 99-426, pp. 402-06; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 922, 923, and 924; S.Rep. 99-313, pp. 370-74; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 609-14 and 626-28 (Conference Report).

Reasons for Change

Congress was concerned that, under prior law, the controlled foreign corporation rules could be manipulated by taxpayers to avoid the provisions of subpart F. Since U.S. control was defined solely in terms of voting power, taxpayers could structure their investments to avoid subpart F by ensuring that they held no more than 50 percent of the voting power of a corporation, even when they held the majority of the value of the corporation in the form of nonvoting stock. Congress noted that the consolidated return rules were amended in 1984 to consider both vote and value because of a similar concern that taxpayers could manipulate a single factor test. Also, Congress mandated vote or value tests for the provisions of the 1984 Act that maintain the character and source of income earned by U.S.-owned foreign corporations and those that extend application of the accumulated earnings tax in the case of U.S.-owned foreign corporations.

Congress believed that the foreign personal holding company rules were similarly subject to manipulation under prior law, since they relied on a single-factor (value) greater-than-50 percent test.

Explanation of Provision

The Act amends the definition of a controlled foreign corporation (sec. 957(a)) to provide that subpart F applies to the U.S. shareholders of a foreign corporation if more than 50 percent of either the voting power or the value of the stock of the corporation is owned by U.S. persons that each own at least 10 percent of the voting power on any day during the taxable year of the foreign corporation. The new vote-or-value rule also applies in determining whether an insurance company is a controlled foreign corporation under the special more-than-25 percent U.S. ownership test of section 957(b).

Similarly, the foreign personal holding company rules apply under the Act if more than 50 percent of either the voting power or the value of a foreign corporation belongs to five or fewer U.S. individuals.

The House version of the tax reform legislation would have decreased the U.S. ownership requirement for controlled foreign corporation status from more-than-50-percent to 50-percent-or-more of total ownership. Congress' decision not to decrease the U.S. ownership requirement in such manner rested, in part, on Congress' understanding that, under an existing Treasury regulation, the IRS can, in appropriate circumstances, deem foreign corporations effectively controlled by 10-percent U.S. shareholders to meet the more-than-50-percent ownership test even though that requirement would otherwise not technically be met (Treas. Reg. sec. 1.957-1(b)).

Effective Date

The provision generally applies to taxable years of foreign corporations beginning after December 31, 1986. However, for purposes of section 956, property acquired before August 16, 1986 is not taken into account with respect to corporations that become subject to subpart F because of this provision.

In the case of an individual who is a beneficiary of a specified trust and who was not a U.S. resident on the date such trust was established, any amounts included by reason of this provision in the gross income of the individual with respect to stock held by the trust (and treated as distributed by the trust) are to be treated as the first amounts distributed by the trust to the individual and as previously taxed income (under sec. 959(a)).

b. Definition of related person (sec. 1221 of the Act and sec. 954 of the Code)

Prior Law

Whether a controlled foreign corporation's income is subject to subpart F will depend in certain cases on whether the income is received from a related person. In general, a related person for purposes of subpart F was defined under prior law (in old sec. 954(d)(3)) as an individual, partnership, trust, or estate which controlled the foreign corporation, a corporation which controlled or was controlled by the foreign corporation, or a corporation which was controlled by the same persons that controlled the foreign corporation. Thus, a partnership, trust, or estate in which a controlled foreign corporation held an interest was not considered a related person under this definition.

For purposes of the above rules, control of a corporation was defined as the direct or indirect ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

Reasons for Change

Congress believed that the exclusion of a controlled partnership, trust, or estate from the subpart F definition of a related person was without logical support. Income that would be treated as subpart F income of a controlled foreign corporation if received from a subsidiary corporation could avoid such treatment under prior law simply by being routed through a controlled partnership instead.

In addition, Congress was concerned that defining control of a corporation solely in terms of voting power made it relatively easy to avoid related person status, and thus possibly to avoid subpart F. This was so because related person status with respect to any given corporation could be avoided without giving control of the corporation to other persons, by structuring an investment in that corporation so that no more than 50 percent of the voting power was held, even though the holder might own a majority of the value of the corporation in the form of nonvoting stock.

Explanation of Provision

The Act expands the definition of related person in section 954(d)(3) to include a partnership, trust, or estate which controls, or is controlled by, a controlled foreign corporation, as well as a partnership, trust, or estate which is controlled by the same persons that control the foreign corporation.

In addition, the Act amends the definition of control for this purpose. In the case of a corporation, control means the direct or indirect ownership of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or of the total value of such corporation. In the case of a partnership, trust, or estate, control is defined as direct or indirect ownership of 50 percent or more of the total value of the beneficial interests in the entity.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 1986.

c. De minimis and full inclusion rules of subpart F (sec. 1223 of the Act and secs. 861, 864, and 954 of the Code)

Prior Law

The subpart F rules that impose current U.S. tax on income of controlled foreign corporations apply only to certain types of income. One major category of income that is subject to current taxation under subpart F is foreign base company income. Foreign base company income includes passive investment income and certain sales, services, insurance, shipping, and oil related income. Under prior law, a de minimis rule in subpart F provided that if less than 10 percent of a foreign corporation's gross income was base company income, then none of the income would be treated as base company income. On the other hand, under prior law, if more than 70 percent of a foreign corporation's gross income was base company income, then all of its income would be treated as base company income.

Reasons for Change

Congress was concerned that the 10-percent de minimis rule allowed taxpayers to earn substantial amounts of tax haven income (such as interest) free of current tax under subpart F. Congress believed that the 10-percent de minimis threshold for subpart F taxation of tax haven income should be reduced; a corporation should not be excepted from subpart F when a substantial amount of its income is tax haven income.

Congress also did not believe that U.S. shareholders of controlled foreign corporations should avoid current U.S. tax on an amount of tax haven income equal to a fixed percentage of the gross income of the controlled foreign corporation without regard to how large, in absolute dollar terms, that amount of tax haven income is. Permitting $1 million or more of tax haven income to avoid current U.S. tax, as the prior law de minimis rule did in the case of a controlled foreign corporation with $10 million or more of gross income, was inconsistent with the de minimis concept in Congress' view.

Explanation of Provision

Under the Act, none of a controlled foreign corporation's gross income for a taxable year is treated as foreign base company income or tax haven insurance income if the sum of the corporation's gross foreign base company and gross tax haven insurance income for the year is less than the lesser of 5 percent of its gross income, or $1 million.

As discussed in more detail at A.2., above, the new subpart F de minimis rule applies for separate foreign tax credit limitation purposes also. Congress accepted a de minimis exception to the separate limitations in the case of controlled foreign corporations to simplify the operation of the foreign tax credit limitation look-through rules. However, Congress concluded that any de minimis exception applicable to the separate limitations should be a limited one, incorporating a reasonable dollar ceiling.

As discussed above at C.1., the Act expands the definition of tax haven insurance income. The general de minimis exception is amended to apply to tax haven insurance income generally in order to preserve de minimis relief for insurance income subject to tax under subpart F under prior law, and to provide such relief to the new types of insurance income (including certain captive insurance income) subjected to tax under subpart F by the Act. Income from insuring U.S. risks was eligible for a special 5-percent de minimis exception under prior law. However, the Act repeals that exception in connection with its expansion of the definition of tax haven insurance income to include income from insuring certain unrelated party foreign risks. Income from the insurance of certain foreign risks of related parties that was subpart F income under prior law was eligible for the general de minimis exception.

The Act provides that if more than 70 percent of a controlled foreign corporation's gross income is base company income and/or tax haven insurance income, then all of its income is treated as foreign base company income or tax haven insurance income (whichever is appropriate). Congress extended the 70-percent full inclusion rule to tax haven insurance income generally because it did not believe that a sound policy basis existed for distinguishing tax haven insurance income from foreign base company income for purposes of either the de minimis rule or the full inclusion rule. This 70-percent full inclusion rule does not apply, however, to income of a company that is a controlled foreign corporation only for purposes of the captive insurance company provision (new Code sec. 953(c)).

The Tax Reform Act of 1984 generally subjects related party factoring income and similar income to taxation under subpart F without regard to the general de minimis rule. The Act does not alter the law in this regard.

Effective Date

The amendments to the de minimis and full inclusion rules apply to taxable years of foreign corporations beginning after December 31, 1986.

d. Possessions corporations (sec. 1224 of the Act and sec. 957 of the Code)

Prior Law

A corporation chartered in the possessions was not considered a controlled foreign corporation under prior law if (1) at least 80 percent of the corporation's gross income was from sources within a possession, and (2) at least 50 percent of the corporation's gross income was from the active conduct of a manufacturing, processing, fishing, mining, or hotel business. Thus, the tax-haven type (subpart F) income of such corporations was not taxed currently to controlling U.S. shareholders. This provision was enacted in 1962 in conjunction with the enactment of subpart F, and was intended to promote investments in active businesses in the possessions.

Reasons for Change

Congress believed that the exemption from controlled foreign corporation status available to possession-chartered corporations was poorly targeted to the creation of employment-producing investment in the possessions. The exemption of tax haven income from current taxation under subpart F did not appear to provide incentive for the type of substantial economic activity that is needed to promote employment and economic development in the possessions.

Explanation of Provision

The exemption from controlled foreign corporation status available to possession-chartered corporations is repealed. Thus, U.S. shareholders of possessions corporations are treated like U.S. shareholders of other foreign corporations, so they are subject to current U.S. tax under subpart F on tax haven-type income of the corporations.

Effective Date

The provision generally applies to taxable years of foreign corporations beginning after December 31, 1986. However, for purposes of section 956, property acquired before August 16, 1986 is not taken into account with respect to corporations that become subject to subpart F because of this provision.

Revenue Effect of Subpart F Provisions

The Act's subpart F amendments (other than the captive insurance provisions) are estimated to increase fiscal year budget receipts by a total of $74 million in 1987, $144 million in 1988, $141 million in 1989, $156 million in 1990, and $170 million in 1991. The captive insurance provisions are estimated to increase fiscal year budget receipts by $20 million in 1987, $34 million in 1988, $38 million in 1989, $43 million in 1990, and $49 million in 1991.

3. Application of accumulated earnings tax and personal holding company tax to foreign corporations (sec. 1225 of the Act and secs. 535 and 545 of the Code)[8]

Prior Law

The accumulated earnings tax is imposed on corporations that accumulate earnings beyond the reasonable needs of their businesses rather than distributing them to their shareholders. The personal holding company tax is imposed on certain corporations receiving defined forms of passive income. The taxes are imposed on accumulated taxable income and undistributed personal holding company income, respectively. Those amounts are calculated by making several adjustments to the regular taxable income of a corporation, including deductions for net capital gains (and certain capital losses). A deduction for net capital gains is granted because the corporate tax rate on capital gains has been greater than the individual tax rate on capital gains, so there has been little incentive to accumulate capital gains in a corporation.

Foreign corporations are generally subject to these taxes if they have any shareholders that would be subject to U.S. tax on a distribution from the corporation. In the case of a foreign corporation, only U.S. source income enters into the calculation of the accumulated earnings tax or personal holding company tax. However, U.S. source net capital gains could be deducted from taxable income for this purpose (thus reducing the accumulated earnings tax or personal holding company tax), even if the capital gain was not otherwise taken into account for U.S. tax purposes because it was not effectively connected with a U.S. trade or business. Thus, U.S. source capital gains that were not subject to U.S. tax could nevertheless reduce the accumulated earnings tax or personal holding company tax. U.S. source capital gains realized by a foreign corporation as a result of trading in stock, securities, or commodities for its own account are not considered effectively connected income.

Reasons for Change

A foreign corporation could use the net capital gain deduction to avoid application of the accumulated earnings tax or personal holding company tax, even when the corporation accumulates substantial gains that are not subject to U.S. tax. In such a case the reason for the capital gain deduction—that the corporate rate on capital gains exceeds the individual rate—was absent, since the corporate tax rate on the gains was zero. U.S. individuals could use such a corporation to accumulate, and defer U.S. taxation of, gains from investments in stock, securities, or commodities. Congress did not believe that taxpayers should be permitted to use such a device to avoid application of the accumulated earnings tax or personal holding company tax. Therefore, Congress concluded that in the case of a foreign corporation a net capital gain deduction for accumulated earnings tax or personal holding company tax purposes should be allowed only with respect to gains that are taxed in the United States.

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[8] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 626; H.Rep. 99-426, pp. 436-438; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 926; S.Rep. 99-313, pp. 431-432; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 628 (Conference Report).

Explanation of Provision

The Act amends sections 535 and 545 to provide that the accumulated earnings tax and the personal holding company tax applicable to a foreign corporation will be calculated by taking net capital gains into account only if they are effectively connected with the conduct of a U.S. trade or business. Gains which are exempt from U.S. tax under a treaty obligation of the United States will not be considered effectively connected for this purpose.

Effective Date

The provision is to apply to gains and losses realized on or after January 1, 1986.[9]

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

4. Deduction for dividends received from certain foreign corporations (sec. 1226 of the Act and secs. 245 and 959 of the Code)[10]

Prior Law

Under prior law, corporations that received dividends from U.S. corporations generally were entitled to a deduction equal to 85 percent of the dividends received (Code sec. 243(a)(1)) (under the Act, this has been reduced to 80 percent) or 100 percent where 80 percent or more of the stock of a corporation is owned by the shareholder (sec. 243(a)(2) and (3)). Dividends received by a U.S. corporation from a foreign corporation generally were not eligible for the dividends received deduction, even though the foreign corporation may have paid U.S. income tax. However, a portion of the dividends paid by a foreign corporation to a U.S. corporate shareholder was eligible for the dividends received deduction where at least 50 percent of a foreign corporation's gross income was effectively connected with a U.S. trade or business during an uninterrupted period of 36 months ending with the close of the year in which the dividends were paid (or for the period of the corporation's existence, if shorter). That portion generally was based on the percentage of the foreign corporation's gross income that was effectively connected with its U.S. trade or business (sec. 245). Under present and prior law, where a foreign corporation is wholly owned by a U.S. corporation and all of its income is effectively connected with a U.S. trade or business, dividends paid by such corporation generally are eligible for a 100-percent dividends received deduction.

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[9] A technical correction will be needed to codify the January date.

[10] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 987; S.Rep. 99-313, pp. 374-378; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 628-630 (Conference Report).

Under present and prior law, if a U.S. corporation is eligible to claim a deduction for dividends received from a foreign corporation, the U.S. recipient treats as U.S. source income for foreign tax credit purposes 100/85 of the amount of the dividend eligible for the dividends received deduction (sec. 861(a)(2)(B)). The Tax Reform Act of 1984 similarly provided rules that convert what would otherwise be foreign source income into U.S. source income if paid by certain entities. In the case of dividends paid by a foreign corporation, these rules apply if the foreign corporation is beneficially owned 50 percent or more by U.S. persons and has earnings from U.S. sources. In such cases, dividends paid are treated as U.S. source to the extent the dividends are attributable to U.S. source earnings of the corporation.

Reasons for Change

Congress recognized that in a two-tiered tax system such as in the United States, double taxation occurs (one tax at the corporate level and a second tax at the individual shareholder level at the time of distributions). The dividends received deduction is intended to mitigate double taxation of U.S. corporations with respect to the same earnings. Congress recognized that prior law's deduction for dividends received from foreign corporations achieved this purpose in the case of a U.S. corporate shareholder of a foreign corporation with a U.S. branch that engaged in a U.S. trade or business, where the income from that trade or business met the 50-percent income threshold. Congress was concerned, however, that the purpose of the deduction was not achieved in other circumstances and believed that modifications to prior law were warranted.

Under prior law, if earnings of a domestic corporation, owned by a foreign corporation which was in turn owned by another domestic corporation, were remitted to the ultimate U.S. owners, the United States subjected the same earnings to more than one U.S. corporate tax. Congress did not believe this result reflected the purpose of the dividends received deduction. Congress also noted that the effect of prior law was to favor a branch operation over a subsidiary operation since earnings paid by a U.S. subsidiary to a foreign parent were not eligible for the dividends received deduction when distributed to the foreign corporation's U.S. shareholders. Congress did not believe this preferential treatment was appropriate. However, to avoid administrative problems for the Internal Revenue Service in administering the laws and to approximate the policy of the indirect foreign tax credit (which attempts to treat foreign taxes paid by subsidiaries like foreign taxes paid by branches), Congress believed that it was appropriate to allow the deduction only to those U.S. shareholders who own a substantial portion of the foreign corporation's shares. Congress also believed that these shareholders should be able to receive the necessary information to determine the portion of dividends that are attributable to U.S. earnings of the foreign corporation.

In determining the amount eligible for the deduction, prior law could also have resulted in inappropriate distortions. Assume, for example, that a foreign corporation earned $100 of gross income effectively connected with its U.S. trade or business and earned $100 of foreign source gross income. Because prior law's deduction was based on the ratio of U.S. gross income to total gross income, U.S. shareholders of the corporation were able to exclude 50 percent of any dividends (subject to the percentage limitation) received from the corporation without regard to the expenses associated with the income. If the corporation incurred $100 or more of expenses in generating the U.S. effectively connected income, the dividends received deduction would still have been available even though there were no U.S. earnings available for distribution. On the other hand, if the foreign corporation's expenses were entirely attributable to non-U.S. effectively connected income, the deduction would have been limited to one-half of any dividend, even though the entire dividend was attributable to U.S. income. Congress did not believe these results were appropriate. In Congress' view, the determination of the deduction should be based on net U.S. earnings of the corporation.

Because dividends from foreign corporations are generally treated as foreign source, an allowance for a dividends received deduction without any change to the source rules or to the indirect foreign tax credit rules could have provided a double benefit to U.S. persons. If a U.S. person is able to treat as foreign source any part of the dividend attributable to U.S. earnings (and which is not offset by the dividends received deduction), the taxpayer may be able to offset the U.S. tax on such portion with excess foreign tax credits from other operations. Similarly, if a U.S. shareholder is able to claim an indirect foreign tax credit on income properly treated as U.S. source, the taxpayer may be able to credit those indirect foreign taxes against U.S. tax on unrelated, possibly low-taxed, foreign source income. The United States would, therefore, relinquish tax that it should collect on dividends paid by U.S. corporations. Congress did not believe these potential additional benefits were appropriate. Moreover, Congress realized that to treat U.S. source income as foreign source income merely because it passed through an intervening foreign corporation circumvented the purpose of the foreign tax credit limitation. Consequently, the Act modifies the source rules for dividends eligible for the deduction.

Explanation of Provision

Dividends received deduction

Under the Act, the deduction for dividends received from foreign corporations is modified in several important respects. First, the deduction is eligible only to corporations that own, by vote and value, at least 10 percent of the stock of a foreign corporation.

Second, the deduction is allowed if the foreign corporate payor earns any amount of income effectively connected with the conduct of a U.S. trade or business that is subject to U.S. tax (*i.e.*, is not treaty protected) or owns a U.S. subsidiary from which it receives dividends. Thus, the Act treats dividends from U.S. subsidiaries like income from U.S. branch operations. The Act also provides that the deduction is available if the dividends from the U.S. corporation are paid through a second wholly-owned foreign corporation before they are remitted to the ultimate corporate shareholder.

The Act defines U.S. subsidiary as a corporation at least 80 percent of the total voting power and value of which is held by a foreign corporation.

Third, the Act provides that dividends eligible for the deduction are based on the proportion of the foreign corporation's post-1986 earnings and profits that have been subject to U.S. corporate income tax and that have not been distributed to the corporation's total accumulated earnings and profits (rather than on the amount of gross income as under prior law). For this purpose, the "pooling" rules adopted by Congress for Code section 902 (sec. 1202 of the Act) apply to a foreign corporation's total accumulated earnings and profits and the accumulated earnings and profits that are attributable to U.S. sources. Therefore, in addition to the pools required for separate foreign tax credit limitations, the foreign corporation must maintain a separate pool for earnings attributable to U.S. sources. Congress intended that distributions from a foreign corporation be deemed to come pro rata from the corporation's earnings that have been subject to U.S. corporate income tax and those that have not been so subject.

In a technical amendment (to Code sec. 959(d)), the Act clarifies that any amounts of subpart F income previously taxed that are distributed to U.S. shareholders are to reduce U.S. source earnings and profits and total earnings and profits (as the case may be) in arriving at the proportionate amount of the taxable dividend eligible for the deduction. For example, assume a controlled foreign corporation derives $20 of subpart F income, $40 of income effectively connected with a U.S. trade or business, and $40 of foreign source non-effectively connected, non-subpart F income in 1987. Further assume that the corporation distributes $40 to its only shareholder, a U.S. corporation, in that year. By virtue of the technical amendment, one-half of the $20 taxable dividend is eligible for the dividends received deduction.

Coordination with foreign tax credit limitation

The Act provides that for foreign tax credit purposes, if otherwise treated as foreign source under the Code's general source rules, the entire amount of the dividend eligible for the deduction is treated as U.S. source. As under the Tax Reform Act of 1984, this special sourcing rule applies even when the dividends are paid through more than one foreign corporation.

Further, the Act provides that indirect foreign tax credits are disallowed to the extent the taxes are attributable to income eligible for the dividends received deduction.

The Act's provisions can be illustrated by the following example. Assume a wholly-owned U.S. corporation remits a $100 dividend to its foreign corporate shareholder, the shareholder has $900 of non-effectively connected net income, and the foreign corporation remits a $100 dividend to its 10-percent-owned U.S. corporate shareholder. Under the bill, the U.S. recipient is eligible for a dividends received deduction of $8 (100/1000 × $100 × .80) and has gross U.S. source income of at least $10 (100/1000 × $100). Assuming the same facts above, if a wholly-owned foreign corporation also is interposed between the wholly-owned U.S. corporation and the foreign corporate payor, that corporation has $400 of non-effectively connected net income in addition to the $100 dividend, and that corporation remits $100 to its U.S. parent, the U.S. recipient would be eligible for a deduction of $1.60 and would have gross U.S. source income of at least $2. Any foreign income taxes eligible for the indirect foreign tax credit that are paid with respect to the portion of the dividend eligible for the deduction would be disallowed under the Act.

Effective Date

The provisions affecting the dividends received deduction are effective for distributions out of earnings and profits for taxable years beginning after December 31, 1986. The technical amendment to section 959(d) is effective for distributions after the date of enactment (October 22, 1986).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

D. Special Tax Provisions for U.S. Persons

1. Possessions tax credit (sec. 1231 of the Act and secs. 934 and 936 of the Code)[1]

Prior Law

Law prior to 1976

Special provisions for the taxation of possessions source income were first enacted in the Revenue Act of 1921. These provisions were adopted primarily to help U.S. corporations compete with foreign firms in the Philippines (then a U.S. possession), although in recent years most of the tax benefit is claimed by corporations located in Puerto Rico. Under the 1921 Act, qualified corporations deriving 80 percent or more of their income from U.S. possessions were exempted from income tax on their foreign source income. To qualify for the exemption, at least 50 percent of the corporation's income had to be derived from the conduct of an active trade or business (as opposed to passive investment income). Dividends paid to a U.S. parent from a qualified possessions subsidiary were taxable, while liquidating distributions were tax-exempt. Since the Puerto Rican Industrial Incentives Act of 1948, most possessions subsidiaries have operated under a complete or partial exemption from Puerto Rican taxes. Thus, a U.S. subsidiary doing business in Puerto Rico could have avoided both Federal and local tax by accumulating operating income until its grant of local exemption expired, and then liquidating into the mainland parent.

Tax Reform Act of 1976

Although the Philippines ceased to be a U.S. possession in 1946, the special tax treatment of possessions corporations remained unchanged until the Tax Reform Act of 1976.[2] In 1976, Congress indicated that Federal tax exemption had played an important role in Puerto Rican economic development. In the Finance Committee Report accompanying the 1976 Act,[3] the purpose of the special tax treatment of possessions-source income was said to be "[to] assist the U.S. possessions in obtaining employment producing investments by U.S. corporations." The need for special tax incentives was attributed, in part, to the additional costs imposed by possessions status, such as the U.S. minimum wage standards and the requirement to use U.S. flag ships.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 641; H.Rep. 99-246, pp. 413-429; H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 941; S.Rep. 99-313, pp. 379-384; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 631-634 (Conference Report).

[2] In 1954, these provisions were incorporated in Code section 931. Possessions to which special tax rules presently apply include Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands.

[3] Report of the Committee on Finance, United States Senate, on H.R. 10612, Sen. Rpt. 94-938 (June 10, 1976), p. 279.

It appeared that several features of the possessions tax system had a high revenue cost with little corresponding benefit to employment or investment in the possessions. To avoid U.S. tax on dividends paid to a mainland parent, possessions subsidiaries invested accumulated earnings from operations in foreign countries, either directly or through the Puerto Rican banking system. Thus, the benefits of the possessions tax exemption were not limited to investments in the possessions.[4]

The 1976 Act added section 936 to the Internal Revenue Code, which altered the taxation of U.S. chartered possessions corporations. To more closely conform the tax treatment of possessions income with the taxation of foreign source income, the exemption was converted to a credit. Thus, possessions-source income was included in the definition of the possessions corporation's worldwide income. However, in lieu of the ordinary foreign tax credit (for income taxes paid to foreign governments) a tax credit was enacted (the possession tax credit) for the full amount of U.S. tax liability on possessions source income. This is referred to as "tax sparing" since a credit is granted whether or not foreign taxes are paid. Dividends repatriated from a possessions corporation qualify for the dividend-received deduction, which allows tax-free repatriation of possessions income.[5]

The 1976 Act defined qualified possessions-source investment income ("QPSII") to include only income attributable to the investment of funds derived from the conduct of an active trade or business in the possessions. The intent was to provide tax benefits to investment income only when this income resulted from an active investment in the possessions. Income from investments in financial intermediaries, such as possession banks, was made eligible for the credit only if it could be shown that the financial intermediary reinvested the funds within the possession in an active business.

The Government of Puerto Rico has established rules (reg. 3087) which apply to financial institutions that accept deposits from possessions corporations. The purpose of these rules is to require that such deposits be invested only in specified assets located in Puerto Rico including: loans for commercial, agricultural, and industrial purposes; business and residential mortgage loans; loans and investments in securities of the government of Puerto Rico and its instrumentalities; student loans; and automobile loans. In addition, financial institutions are required to invest 30 percent of possessions corporation deposits in Puerto Rico Government obligations, including 10 percent in obligations of the Government Development Bank for Puerto Rico ("GDB").

Tax Equity and Fiscal Responsibility Act of 1982

Despite the provisions in the 1976 Act, Congress in 1982 was concerned that the possession tax credit was costly and inefficient. According to the Finance Committee Report on the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA):[6]

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[4] U.S. General Accounting Office, *Puerto Rico's Political Future: A Divisive Issue with Many Dimensions* (March 2, 1981), GGD-81-48, p. 69.

[5] Dividends paid by a section 936 corporation generally qualify for a 100-percent dividends received deduction (sec. 243(a)(3)).

"Treasury's three reports to date have confirmed the existence of two problems in that system: (1) unduly high revenue loss attributable to certain industries due to positions taken by certain taxpayers with respect to the allocations of intangible income among related parties, and (2) continued tax exemption of increased possession source investment income."

In addition, there was considerable disagreement under prior law regarding the extent to which intangible assets could be transferred to a possessions corporation free of U.S. tax. In July of 1980, the Internal Revenue Service issued Technical Advice Memorandum 8040019 which stated that intangibles transferred to a possessions subsidiary at less than a reasonable arm's-length price did not belong to the subsidiary, and the income derived therefrom was allocable to the parent corporation rather than the subsidiary.

The 1982 Act addressed these issues by (1) increasing the active possession business income percentage requirement for possessions corporation status from 50 to 65 percent of gross income and (2) limiting the credit on intangible income of possessions corporations. A possessions corporation is allowed a credit with respect to intangible income only if it elects one of two optional methods of computing taxable income: (1) the cost sharing method or (2) the 50/50 profit split method.

Under the cost sharing method, a possessions corporation is permitted to claim a return on manufacturing (but not marketing) intangibles in computing its income from products it produces, provided that it makes a (taxable) cost-sharing payment to its affiliates. The payment represents the possessions corporation's share of its affiliated group's worldwide direct and indirect research and development (R&D) expenditures in each product area in which the possessions corporation manufactures products subject to the cost sharing election. The possessions corporation's share of R&D expense is determined by reference to the ratio of third-party sales by members of its affiliated group of those products within a given product area, which are produced in whole or in part by the possessions corporation, to such sales of all products within that product area. The cost sharing payment effectively increases the taxable income of the possessions corporation's mainland affiliate and, consequently, its tax liability.

Under the 50/50 profit split method, the possessions corporation's taxable income (eligible for the credit) with respect to any product it produces in whole or in part is equal to 50 percent of the combined taxable income of the domestic members of its affiliated group with respect to covered sales of such product. The combined taxable income associated with a product is determined as the excess of gross receipts (on sales of the product to foreign affiliates or third parties) over the direct and indirect costs of producing and marketing the product. Thus, to the the extent that combined taxable income represents a return on intangible assets (both manufacturing and marketing intangibles), half of this intangible income is eligible for section 936 tax benefits.

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[6] Sen. Rept. No. 97-494, (July 12, 1982). pp. 81-2.

For purposes of computing the combined taxable income of which 50 percent is allocated to the possessions corporation, the amount of the group's R&D expenses allocated to income from the sale of a product (or service) generally cannot be less than the portion of the cost sharing payment (that is required under the cost sharing method) for the product area that is allocable to the product (service).[7]

To derive intangible income on a tax-free basis, the possessions corporation (and all corporations in the affiliated group that make products or render services in the same product area) must make an irrevocable election to use one of the two methods. A single method must be selected for all products within a product area.[8] In addition, neither method may be used for a product which does not meet the significant business presence test. A product satisfies this test if either (1) at least 25 percent of the value added to the product is a result of economic activity in the possessions or (2) at least 65 percent of the direct labor cost for the product is incurred in the possessions. Finally, the TEFRA generally prohibited possessions corporations from making future tax-free transfers of intangibles to foreign corporations.

Reasons for Change

Congress believed that the credit and complementary local tax incentives had promoted economic growth in Puerto Rico (and in the other possessions and the Virgin Islands). Moreover, Congress understood that the Government of Puerto Rico is developing a "twin-plant" program to encourage companies with operations in Puerto Rico to develop or expand manufacturing operations in qualified Caribbean Basin Initiative ("CBI") countries. Consequently, Congress anticipated that continuation of the possession tax credit would promote economic development both in the possessions and in qualified CBI countries.

The Act modifies the credit to encourage more employment-producing investment per dollar of revenue loss to the Treasury. Also, the Act drops certain restrictions regarding qualified possessions source investment income ("QPSII") to allow the Government of Puerto Rico to implement its twin plant program.

Preliminary 1983 data indicate that the changes to the possessions tax credit in 1982 reduced the amount of credits claimed by less than was anticipated in the revenue estimates accompanying TEFRA. This discrepancy appears primarily attributable to the operation of the cost sharing election. Problems with the cost sharing method may arise in situations where, for example, possessions products fall outside the U.S. affiliate's main area of research, or a possessions corporation utilizes the U.S. affiliate's most valuable intangibles. In response to these concerns, the Act increases the amount of payments required under the cost sharing method.

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[7] The portion of the cost sharing payment allocable to the product (service) is that portion which gross income from the product (service) bears to gross income from all products (services) within the product area.

[8] Export sales within a product group are exempt from this requirement.

A significant portion of the possessions tax credit is attributable to income generated from passive investments. Deposits of possessions corporations constitute over one-third of commercial bank liabilities in Puerto Rico.[9] Investment income generally qualifies for the possessions tax credit only if it is derived from funds reinvested in the possessions for use therein. The Puerto Rican authorities have been concerned that these funds are being invested outside Puerto Rico (primarily in the Eurodollar market). The Puerto Rican Treasury Department issued regulations in 1980 and in 1984 that seek to prevent these funds from flowing out of Puerto Rico, but it remains unclear the extent to which these deposits have increased physical investment in Puerto Rico.

Congress believed that requiring possessions corporations to derive a larger fraction of their income directly from the conduct of an active trade or business would better achieve the objectives of creating employment-producing investment in the possessions. Moreover, Congress believed, in view of the Act's restrictions on tax exempt industrial development bonds, that it would be appropriate to restrict to some extent the volume of tax exempt possessions assets issued to U.S. investors.

Under prior law, the possessions tax credit was denied for otherwise eligible income if receipt occurred in the United States. The Act deletes the U.S.-receipt rule for active business income derived from unrelated parties because in certain situations, where payment must be received in the United States (e.g., certain defense contracts), the rule may discourage production in the possessions.

Explanation of Provision

The Act retains the possessions tax credit as amended by the TEFRA, with six principal modifications.

First, the cost sharing payment required for companies that elect the cost sharing option is set equal to the greater of: (1) 110 percent of the payment required under prior law or (2) the royalty payment or inclusion that would be required (under sections 482 and 367 as modified by section 1231(e) of the Act) with respect to intangibles the possessions corporation is treated as owning under the cost sharing option, if the possessions corporation were a foreign corporation (whether or not intangibles actually are transferred to the possessions corporation).

Second, for companies that elect the profit split option, the amount of product area research expenditures (as determined under the cost sharing rules without regard to changes in the 1986 Act) is increased by 20 percent for purposes of computing combined taxable income. This increases the amount of income allocable to nonpossessions affiliates by no more than the increase under the Act for companies that elect the cost sharing option.[10] The Act also

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[9] Under the Puerto Rican Industrial Incentives Act of 1978, income derived from a business operating under a tax-exemption grant may be reinvested free of Puerto Rican tax in certain assets, including term deposits in qualifying Puerto Rican banks.

[10] For example, if product area research expenditures allocable to a product are $10 for a taxable year, then under prior law at least $10 of research cost must be taken into account in computing the product's combined taxable income for that taxable year. The Act requires that at least $12 (120 percent of $10) of research cost be taken into account in computing the prod-

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makes a technical correction (to the TEFRA) regarding the computation of combined taxable income under the profit split method.[11]

Congress expected that the Secretary would take into account the significant nature of the modifications made by the conference agreement to the computation of possessions source income in cases where an electing corporation seeks to change its method of computation.

Third, the Act modifies the rule in present law (sec. 936(b)) which denies the credit with respect to income received in the United States (not including possessions thereof). The credit is not denied for tax on otherwise eligible active business income solely by reason of receipt in the United States where such income is received from an unrelated party. Prior law is retained for investment income and for business income received from related parties.

Fourth, the Act changes the active trade or business test that a U.S. corporation must meet to qualify for the possessions tax credit. Under prior law, 65 percent or more of a possessions corporation's gross income for the three-year period immediately preceding the close of the taxable year had to be derived from the active conduct of a trade or business in the possessions. The Act increases the active income requirement from 65 percent to 75 percent for taxable years beginning after 1986. The Act does not alter the prior law requirement that 80 percent or more of gross income for a three-year period be derived from sources within a possession. As under prior law, a possessions corporation must meet both the 80-percent possessions source income test and the active trade or business test.

Fifth, the Act amends section 936(d)(1) to include the U.S. Virgin Islands within the definition of "possession." This change has the effect of bringing U.S. corporations doing business in the Virgin Islands within the scope of section 936, rather than the separate but comparable provisions of the revised Organic Act of the Virgin Islands and section 934.

Sixth, the Act modifies the definition of qualified possession source investment income ("QPSII") in order to allow the Government of Puerto Rico to implement its initiative to increase investment and employment in qualified Caribbean Basin Initiative ("CBI") countries. The Act expands the definition of QPSII to include certain investments outside of the possessions. Subject to such conditions as the Secretary of the Treasury may prescribe by regulations, QPSII includes income derived from loans by qualified financial institutions (including the Government Development Bank and the Puerto Rico Development Bank) for the acquisition or construction of active business assets and for construction of development projects located in qualified CBI countries. Financial in-

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uct's combined taxable income. Consequently, the combined taxable income from sales of the product is reduced by at most $2 ($12 minus $10), and the amount of income allocable to nonpossessions affiliates is increased by at most $1 (50 percent of $2) for companies electing the profit split option. For companies electing the cost sharing option, the Act requires an increase in the cost sharing payment for this product, and thus the amount of income allocable to nonpossessions affiliates, of at least $1 (10 percent of $10).

[11] The Act clarifies that the portion of the cost sharing payment allocable to a product or service, for purposes of computing combined taxable income, is that portion which gross income from the product bears to gross income from all products *within the product area* (rather than within all product areas). This clarification applies as if enacted as part of TEFRA.

stitutions may include banks, investment banks, or similar institutions. To qualify for QPSII treatment, such loans must be approved by the GDB pursuant to regulations issued by the Secretary of the Treasury of Puerto Rico.

A qualified CBI country is defined as a "beneficiary country" (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act) which meets the requirements of clauses (i) and (ii) of Code section 274(h)(6)(A) (relating to exchange of information agreements and nondiscrimination). A development project generally means an infrastructure investment, such as a road or water treatment facility, that directly supports industrial development. Active business assets generally mean plant, equipment, and inventory associated with a manufacturing operation.

To qualify, a financial institution must agree to permit the Secretary and the Secretary of the Treasury of Puerto Rico to examine such of its books and records as may be necessary to ensure compliance with these provisions. In addition, the borrower and the institutional lender must certify to the Secretary and the Secretary of the Treasury of Puerto Rico that the funds will be invested promptly in active business assets or a development project located in a qualified CBI country. Congress anticipated that the lending institution would terminate such a loan if the Secretary or the Secretary of the Treasury of Puerto Rico determined that the borrower had not made a good faith effort to comply with the conditions of certification. Also, Congress anticipated that the Government of Puerto Rico would make conforming changes in regulations to permit a local tax exemption for the income attributable to qualified CBI loans.

Congress intends to exercise its oversight jurisdiction to review periodically the operation of the possession tax credit to ensure that the goals of economic development in both the possessions and the Caribbean Basin are being achieved. Congress anticipated that the Government of Puerto Rico would pursue vigorously the twin plant initiative outlined in the "Memorandum of Agreement."[12] The Memorandum of Agreement provides, *inter alia*, that the Government of Puerto Rico will guarantee $100 million annually of new funds for private direct investment in qualified CBI countries. These funds are anticipated to be derived, without additional cost to the United States Treasury, from a variety of sources including: possessions corporations (in exchange for future Puerto Rican tax concessions); GDB funds; and grants by the Government of Puerto Rico.

The Congress intends that Treasury may issue regulations providing additional compliance measures including (1) the submission with the tax return of information relevant to computing income from intangibles, and (2) annual certification by the borrower and lender that CBI loans have been used for investments that are permitted under the QPSII rules.

Treasury regulations issued under section 936(h)(7) can permit the use of the cost sharing and profit split methods in cases where the possessions product is leased, rather than sold (or is used in the trade or business of a member of the affiliated group), but only if (1) an independent sales price can be determined for the product from comparable uncontrolled transactions, and (2) the appropriate member of the group agrees to be treated as having sold the possession product at such price. The Congress intended that an exception to the former requirement be provided under conditions deemed appropriate by the Secretary. Such conditions may restrict relief to situations where (1) the cost sharing payment is no less than 100 percent of the product area research cost incurred by the affiliated group, and (2) the deemed sale of the possessions product units is treated as made at a price which produced a profit to the appropriate member of the group equal to the possessions corporation's tax-exempt profit with respect to the same units (computed without regard to the cost sharing payment), reduced by one-half of the cost sharing payment allocable to such units.

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[12] " Memorandum of Agreement between the Government of the United States and the Government of Puerto Rico (draft)," November 14, 1985.

Effective Date

The possessions tax credit provisions are effective for taxable years beginning after December 31, 1986. The royalty provision of the cost sharing rule applies to taxable years beginning after 1986 without regard to when the transfer or license (if any) of intangibles was made.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $37 million in 1987, $67 million in 1988, $66 million in 1989, $73 million in 1990, and $79 million in 1991.

2. Taxation of U.S. persons in Panama (sec. 1232 of the Act)[13]

Prior Law

Agreement implementing Panama Canal Treaty

The Panama Canal Commission is a U.S. Government agency that carries out the responsibilities of the United States under the Panama Canal Treaty with respect to the management, operation, and maintenance of the Panama Canal. An agreement between the United States and Panama entered into in conjunction with the Panama Canal Treaty (Agreement in Implementation of Article III) specifies the rights and legal status of the Commission and its employees. One article of the agreement provides an exemption from tax for U.S. employees of the Commission. In a diplomatic note, Panama confirmed the United States' explanation that the exemption was intended to apply solely to Panamanian taxes. A similar agreement between the United States and Panama governs the status of U.S. military installations and employees in Panama.

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[13] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 642; H.Rep. 99-426, pp. 427-28; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 942; S.Rep. 99-313, pp. 385-87; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 634-35 (Conference Report).

Tax-free allowance

U.S. Government employees stationed abroad are generally permitted to exclude from gross income certain housing, cost-of-living, and other allowances under Code section 912. The exclusions under section 912 apply only to allowances granted under certain specifically-enumerated statutory provisions. The statutes providing allowances and other benefits to U.S. employees of the Panama Canal Commission are not enumerated in section 912.

In 1984, Congress amended the Panama Canal Act of 1979 to allow the Defense Department to grant quarters allowances to its employees in Panama. Section 912 was not amended to cover allowances granted under the Panama Canal Act, however. Defense Department employees in countries other than Panama receive allowances under an earlier law, the Overseas Differentials and Allowances Act, which is enumerated in section 912.

Reasons for Change

Agreement implementing Panama Canal Treaty

The Agreement in Implementation of Article III of the Panama Canal Treaty (the "Agreement") has been the subject of a substantial amount of litigation. Taxpayers have taken the position that the Agreement exempts the salaries of U.S. employees of the Panama Canal Commission from both U.S. and Panamanian taxation. Although at the time of Congress' consideration of the legislation most courts had upheld the U.S. Government's interpretation of the treaty, *see, e.g., Coplin v. United States*, 761 F.2d 688 (Fed. Cir. 1985), one appeals court had excluded from consideration the U.S. explanation and Panamanian diplomatic note, and held that the plain language of the treaty required a complete exemption from all taxes. *See Harris v. United States*, 768 F.2d 1240 (11th Cir. 1985). Similar controversy may have existed with respect to the Agreement in Implementation of Article IV.

Although the *Harris* court's reading of the Agreement may have been supported by the limited evidence before the court, Congress believed that such a reading of the Agreement was inconsistent with the intent of the drafters and with the views of Congress as reflected in well-established U.S. treaty policy. The United States' technical explanation of the Agreement, the Report of the Senate Foreign Relations Committee, and the diplomatic note provided by Panama established that the treaty was not intended to provide a complete exemption from all taxes for Commission employees. Furthermore, the provision of any such benefit under the treaty would have been inconsistent with the treaty policy of the United States not to alter by treaty the U.S. tax treatment of U.S. persons. Congress found nothing in the legislative history to indicate any earlier Congressional intention to contravene Congress' well-established policies in this regard, in entering into the Panama Canal Treaty and its implementing agreements. In fact, the legislative history indicates that no such contravention was intended.

After the Act was enacted, the U.S. Supreme Court upheld the U.S. Government's interpretation of the Agreement. *See O'Connor v. United States*, No. 85-558, 55 U.S.L.W. 4007 (Nov. 4, 1986). Affirming the decision of the U.S. Court of Appeals for the Federal Circuit in *Coplin v. United States, see above*, the Supreme Court held unanimously that the tax exemption provided in Article XV of the Agreement applies only to Panamanian taxes. The Supreme Court stated in its opinion that it did not rely upon the Act in reaching its decision.

Tax-free allowances

While Congress did not believe that employees of the Panama Canal Commission or civilian employees of the Defense Department should be granted preferential tax treatment, neither did it believe that they should be treated worse than comparable overseas employees of the United States. Thus, Congress decided that such employees should be permitted to exclude from gross income allowances comparable to the allowances paid to certain other U.S. Government employees overseas.

Explanation of Provisions

Agreement implementing Panama Canal Treaty

The Act clarifies that nothing in the Panama Canal Treaty (or in any agreement implementing the treaty) is to be construed as exempting (in whole or in part) any citizen or resident of the United States from any U.S. tax imposed under the Code.

Effective date.—With respect to U.S. taxes not imposed with respect to a taxable year (such as the gift and estate taxes), the clarification is effective for taxable events after the date of enactment. With respect to other U.S. taxes (such as the income tax), the clarification applies to all open taxable years.

Tax-free allowances

The Act provides that employees of the Panama Canal Commission and civilian employees of the Defense Department stationed in Panama may exclude from gross income allowances which are comparable to the allowances excludable under section 912(1) by employees of the State Department stationed in Panama. Congress intended by this exclusion to equalize the treatment of U.S. Government employees stationed in Panama, and thus did not intend to permit the exclusion of amounts greater than those that could be excluded by State Department employees, nor to permit the exclusion of allowances of any type unavailable to State Department employees.

Effective date.—This provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provisions relating to the taxation of U.S. persons in Panama are estimated to reduce fiscal year budget receipts by less than $5 million per year.

3. Reduction of foreign earned income exclusion; disallowance of exclusion for individuals in foreign countries in violation of law (sec. 1233 of the Act and sec. 911 of the Code)[14]

Prior Law

A U.S. citizen or resident is generally taxed on his or her worldwide income, with the allowance of a foreign tax credit for foreign taxes paid on the foreign income. However, under present and prior Code section 911, an individual who has his or her tax home in a foreign country and who either is present overseas for 330 days out of 12 consecutive months or is a bona fide resident of a foreign country for an entire taxable year generally can elect to exclude an amount of his or her foreign earned income from his gross income. The maximum exclusion was $80,000 in 1986 and, under prior law, was scheduled to increase to $85,000 in 1988, $90,000 in 1989, and to $95,000 in 1990 and thereafter.[15]

Under present and prior law, an individual meeting the eligibility requirements generally may also elect to exclude (or deduct, in certain cases) housing costs above a floor amount. The combined earned income exclusion and housing amount exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The provision contains a denial of double benefits by reducing such items as the foreign tax credit by the amount attributable to excluded income.

Reasons for Change

In connection with the lowering of tax rates for U.S. individuals, Congress repealed or restricted a great number of tax preferences. In this context, Congress believed that it was appropriate to reduce the maximum potential preference for Americans earning active income abroad.

In addition, Congress believed that it was inappropriate to extend any foreign earned income exclusion or housing benefit to individuals who are in foreign countries in violation of U.S. travel restrictions carrying criminal sanctions.

Explanation of Provisions

a. Foreign earned income exclusion amount

The Act limits the foreign earned income exclusion to $70,000 per year per U.S. individual. As under prior law, the exclusion is computed at the annual rate on a daily basis.

b. Disallowance of exclusion for individuals in foreign countries in violation of law

The Act provides that individuals who are present in a country with respect to which restrictions relating to travel transactions are in effect lose certain tax benefits, described below. An individual who is present in a foreign country with respect to which U.S. citizens and residents generally are prohibited from engaging in travel-related transactions does not lose tax benefits unless that individual's engaging in travel-related transactions is in violation of law.

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[14] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 644; H.Rep. 99-426, p. 430; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 943 and 988; S.Rep. 99-313, pp. 387-89; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 636 (Conference Report).

[15] This scheduled increase in the exclusion was set in the Deficit Reduction Act of 1984. Under the Economic Recovery Tax Act of 1981, the exclusion was scheduled to increase to $85,000 in 1984, $90,000 in 1985, and to $95,000 in 1986 and thereafter.

For the purposes of this provision, presence in a country generally results in loss of the earned income exclusion if regulations pursuant to the Trading with the Enemy Act or the International Emergency Economic Powers Act prohibit U.S. citizens and residents from engaging in transactions related to travel to, from, or within that country. Under the Act, an individual is not treated as a bona fide resident of, or as present in, a foreign country for any day during which the individual is present in a country in violation of law. Foreign earned income, otherwise eligible for the exclusion, does not include any income from sources within such a country attributable to services performed therein. Housing expenses eligible for tax benefits do not include any expenses (allocable to a period in which presence was prohibited) for housing in such a country or for housing of the spouse or dependents of the taxpayer in another country while the taxpayer is present in such a country.

Under Treasury regulations, transactions related to travel of U.S. citizens and residents in five countries have been generally prohibited, except pursuant to consent of the Treasury Department. These countries are North Korea, Cuba, Vietnam, Kampuchea, and Libya. In certain cases, exceptions to these prohibitions are available. These exceptions differ for the various countries. For instance, American individuals may be present in Cuba to visit close family members, to engage in journalistic activity, or to perform research. The rules related to prohibiting travel transactions with respect to Libya, by contrast, prohibit all travel transactions in Libya after January 31, 1986, unless necessary to effect the individual's departure from Libya or for journalistic activity by persons regularly employed in such capacity by a newsgathering organization. Accordingly, the Act does not deny tax benefits to U.S. persons present in Libya to report news for a newspaper or television network, because such persons are not engaging in transactions there in violation of law.

The Act applies to the extent that any future changes in law prohibit transactions related to travel to, from, or within foreign countries. If future changes occur, presence in these countries from the effective date of the change will constitute presence that does not qualify for tax benefits under the Act.

Effective Date

These changes are effective for all taxable years beginning on or after January 1, 1987.

Revenue Effect

These provisions are expected to increase fiscal year budget receipts by $24 million in 1987, $34 million in 1988, $45 million in 1989, $56 million in 1990, and $61 million in 1991.

4. Transfers of intangibles to related parties (sec. 1231 of the Act and secs. 367, 482, and 936 of the Code)[16]

Prior Law and Background

In general

A U.S. taxpayer may transfer intangible property or rights to use such property to a related corporation that is not subject to current U.S. tax because the related corporation is a foreign corporation or an electing section 936 corporation. (Foreign corporations generally are not subject to U.S. tax unless they receive U.S. source income or have a U.S. business; special rules are provided for electing section 936 corporations that allow them generally not to pay U.S. tax). Various provisions of the Code have attempted to limit the ability to obtain deferral or effective exemption of income attributable to the intangible by shifting the income from a U.S. taxpayer to a related entity not subject to U.S. tax.

Section 482

A related party license or sale of rights to use property is generally subject to the provisions of section 482 of the Code. That section authorizes the Treasury Department to allocate income among related parties as necessary to prevent the evasion of taxes or clearly to reflect the income of such parties.

Treasury Regulations under section 482 have interpreted this provision by attempting to determine what an arm's length charge between unrelated parties would have been. Following this approach, the regulations have provided that appropriate allocations of income to reflect an "arm's length" consideration may be made if intangible property is transferred on other than arm's length terms. To determine an arm's length consideration, the regulations have looked to comparable transactions where they exist, and particularly to transfers by the same transferor to unrelated parties involving the same or similar property under the same or similar circumstances.

Where a sufficiently similar transaction with unrelated parties cannot be found, prevailing rates in the industry and bids of other parties, as well as prospective profits to the transferee, are among the factors that may be considered under the regulations. None of the factors has been accorded special emphasis.

Depending on the circumstances, an arm's length consideration may have taken the form of a stated royalty or lump sum payment. Other methods of allocation could also be appropriate, depending on the circumstances.

Section 367

Where the U.S. taxpayer does not transfer the right to use the intangible to its foreign affiliate in the form of a license or sale, but rather as a transfer of the ownership of the intangible through a contribution to capital, the transfer is subject to section 367.

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[16] For legislative background of the provision, see H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 641; H.Rep. 99-426, pp. 420-427; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 637-638 (Conference Report).

Under that section, transfers of appreciated property, including intangibles, to related foreign corporations by a contribution to capital or similar transaction that would be tax free if made to a U.S. corporation were prior to 1984 generally treated as taxable sales where the transfer had as one of its principal purposes the avoidance of U.S. tax.

The Internal Revenue Service took the position that transfers to foreign corporations of patents, trademarks and similar intangibles for use in connection with a U.S. trade or business, or for use in connection with manufacturing for sale or consumption in the United States, generally had tax avoidance as a principal purpose and would be subject to a "toll" charge under section 367. Rev. Proc. 68-23, 1968-1 C.B. 821. By negative implication, transfers for use purely in connection with a foreign trade or business or manufacturing might have been viewed as nontaxable.

In response to the substantial tax advantages available to taxpayers if they could transfer intangibles to related foreign corporations without a toll charge, as a contribution to capital without the payment of any royalty or any allocation of income, Congress amended section 367(d) in 1984 to provide that except as provided in regulations, a transfer of intangibles to a foreign corporation as a contribution to capital under section 351 or in a reorganization under section 361 would be treated as a sale of the intangibles. Intangibles for this purpose include any (1) patent, invention, formula, process, design, pattern, or know-how, (2) copyright, literary, musical, or artistic composition, (3) trademark, trade name, or brand name, (4) franchise, license, or contract, (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (6) any similar item, which property has substantial value independent of the services of any individual.

Section 367(d) has provided that the amounts included in income of the transferor on such a transfer must reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property. In general, the amounts are treated as received over the useful life of the intangible property on an annual basis. Thus, a single lump-sum payment, or an annual payment not contingent on productivity, use or disposition, cannot be used as the measure of the appropriate transfer price. Any amounts included in gross income by reason of this special rule are treated as ordinary income from sources within the United States.

Section 367 does not apply to transfers to possessions corporations under section 936 because such corporations are U.S. rather than foreign corporations.

Section 936

Because possessions corporations qualifying for the section 936 tax credit are U.S. rather than foreign corporations, section 367 has not applied to transfers of intangibles to possessions corporation by the their U.S. affiliates. Prior to statutory changes made in the 1982 Act, the appropriate treatment of transfers of intangibles to possessions corporations in the form of contributions to capital was not clear.

Some taxpayers took the position that such transfers of intangibles could be accomplished without the payment of any consideration or any allocation of income to the U.S. transferor. The Internal Revenue Service challenged this treatment in a number of cases involving transfers of intangibles to possessions corporations that performed manufacturing functions using the intangibles and sold the products back to U.S. affiliates. The Service argues that these transactions in reality constituted contract manufacturing arrangements. Thus, it contends that the income attributable to the transferred intangible should be allocated entirely to the parent under section 482, with the possessions corporation retaining only a return on its manufacturing operations. In the one case decided on this question at the time of the Act, *Eli Lilly and Company and Subsidiaries*, 84 T.C. 996 (1985), the tax court took an intermediate position. While it noted the absence of any royalty or other payment for the intangible, it did not conclude that under the particular facts such a payment would be mandatory. However, on examination of the entire transaction, the court concluded that, taking into account the prices charged on sales of goods back to the U.S. parent, the allocation of income to the parent was too low and that a substantial portion of the profit from the goods manufactured and sold by the possessions corporation should be allocated to the U.S. parent.

Because of the substantial uncertainty in the area and because it considered the tax advantages claimed by certain taxpayers to be excessive, Congress amended section 936 in 1982 to provide specific rules for the allocation of intangibles income between a possessions corporation and a related entity that transfers intangibles to, or allows their use by, the possessions corporation. Generally, all income attributable to the intangible is taxed directly to the U.S. shareholders unless one of two specified options is elected. One option is a 50/50 profit split under which 50 percent of the profit is allocated to the U.S. parent. The other option is a cost-sharing option, under which the possessions corporation can claim a return on manufacturing (but generally not marketing) intangibles related to the products it produces if it makes a "cost-sharing" payment to its affiliates computed under a specified formula.[17]

If the cost-sharing option is elected, the possessions corporation is treated as the owner of the intangible. However, the principles of section 482 apply in determining the proper selling price of products it produces and sells to its mainland or other affiliate. The principles of section 482 also apply in distinguishing amounts that are attributable to marketing intangibles (such as trademarks, trade names, or corporate knowledge of and contacts with the marketplace) from amounts that are attributable to manufacturing intangibles (such as patents or know-how).

Reasons for Change

There was a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers could result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.

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[17] These provisions are discussed in greater detail in connection with the amendments dealing with section 936 possessions corporations (sec. 1231 of the Act).

Congress was concerned that the provisions of sections 482, 367(d), and 936 that allocate income to a U.S. transferor of intangibles may not have been operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations.

Many observers have questioned the effectiveness of the "arm's length" approach of the regulations under section 482. A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables.[18]

A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. Observers have noted that multinational companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries.[19] In addition, a parent corporation that transfers potentially valuable property to its subsidiary is not faced with the same risks as if it were dealing with an unrelated party. Its equity interest assures it of the ability ultimately to obtain the benefit of future anticipated or unanticipated profits, without regard to the price it sets. The relationship similarly would enable the parent to adjust its arrangement each year, if it wished to do so, to take account of major variations in the revenue produced by a transferred item.

The problems have been particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may have transferred such intangibles to foreign related corporations or to possessions corporations at an early stage, for a relatively low royalty, and taken the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently have taken the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items.

Certain judicial interpretations of section 482 have suggested that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a "safe harbor" for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. *See, e.g., United States Steel Corporation v. Commissioner*, 617 F. 2d 942 (2d Cir. 1980). While Congress was concerned that such decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services, it believed that such an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfers of intangibles was necessary.

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[18] See, *e.g.*, U.S. General Accounting Office, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (GGD-81-81, September 30, 1981); Schindler and Henderson, Intercorporate Transfer Pricing 1985 Survey of Section 482 Audits (1985) and materials cited therein. Cf. Department of the Treasury, Internal Revenue Service, *IRS Examination Data Reveal an Effective Administration of Section 482 Regulations*, Report prepared by The Assistant Commissioner (Examinations). April, 1984.

[19] Schindler and Henderson, *supra* n.18, at p. 6. See GAO report, *supra* n.18.

In many cases firms that develop high profit-potential intangibles tend to retain their rights or transfer them to related parties in which they retain an equity interest in order to maximize their profits. The transferor may well be looking in part to the value of its direct or indirect equity interest in the related party transferee as part of the value to be received for the transfer, rather than to "arm's length" factors. Industry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases.

Transfers between related parties do not involve the same risks as transfers to unrelated parties. There is thus a powerful incentive to establish a relatively low royalty without adequate provisions for adjustment as the revenues of the intangible vary. There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. Congress thus concluded that it is appropriate to assure that the division of income between related parties reasonably reflect the relative economic activities undertaken by each. Congress believed that payments made on a transfer of intangibles to a related foreign corporation or possessions corporation should be commensurate with the income attributable to the intangible.

With respect to possessions corporations electing the cost-sharing option under section 936, Congress was concerned that the cost-sharing payment computed under prior law may not always have allocated sufficient income to mainland affiliates with respect to manufacturing intangibles the possessions corporations were treated as owning under that option. The option looks to a sharing of costs that may be insufficiently related to the highly profitable intangible actually transferred. Congress believed that an appropriate floor for the cost-sharing payment is the royalty the possessions corporation would pay under section 482 or 367 principles, were they applicable with respect to such manufacturing intangibles.

Explanation of Provisions

The basic requirement of the Act is that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. This requirement is established to fulfill the objective that the division of income between related parties reasonably reflect the relative economic activity undertaken by each. This approach applies both to outright transfers of the ownership of the intangibles (whether by sale, contribution to capital, or otherwise), and to licenses or other arrangements for the use of intangibles.

In making this change, Congress intended to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor payment for related party intangibles transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. In determining whether the taxpayer could reasonably expect that projected profits would be greater than the industry norm, Congress intended that there should be taken into account any established pattern of transferring relatively high profit intangibles to U.S. possessions or low tax foreign locations.

Congress did not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. Congress intended that consideration also be given to the actual profit experience realized as a consequence of the transfer. Thus, Congress intended to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible. The Act is not intended to require annual adjustments when there are only minor variations in revenues. However, it will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible.

In requiring that payments be commensurate with the income stream, the Act does not intend to mandate the use of the "contract manufacturer" or "cost-plus" methods of allocating income or any other particular method. As under prior law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties' marketing efforts. However, the profit or income stream generated by or associated with intangible property is to be given primary weight.

The requirements of the Act apply when intangibles of the type presently subject to section 367(d) are transferred by a U.S. person to a related foreign entity or to a possessions corporation that elects the cost-sharing option, or are licensed or otherwise used by such entity. Thus, the standard that payments must be commensurate with the income attributable to the intangible applies in determining the amounts to be imputed under section 367(d) and in determining the appropriate section 482 allocation in other situations. The standard also applies in determining the minimum amount of the "cost-sharing payment" to be made under the cost-sharing option in the case of an electing section 936 corporation. As discussed in greater detail in connection with the changes made by the Act affecting possessions corporations, the Act requires that the cost-sharing payment be at least as great as the royalty the possessions corporation would have to pay to an affiliate under section 367 or 482 with respect to manufacturing intangibles the possessions corporation is treated as owning by virtue of electing the cost-sharing option.

In view of the fact that the objective of these provisions—that the division of income between related parties reasonably reflect the relative economic activity undertaken by each—applies equally to inbound transfers, Congress concluded that it would be appropriate for these principles to apply to transfers between related parties generally if income must otherwise be taken into account.

Congress did not intend to affect present law concepts of what constitutes a single "license", to the extent those concepts are not inconsistent with the purposes of the new provision. Thus, for example, in the case of continuous transfers of technology under a continuing license agreement, the adequacy of the royalty may, in appropriate cases, be determined by applying the appropriate standards under the Act on an aggregate basis with respect to the profitability and other relevant features of the transferred intangibles as a whole.

Similarly, Congress did not intend to change principles that would permit offsets or other adjustments to reflect the tax impact of the taxpayer's transactions as a whole.

Congress was also aware that many important and difficult issues under section 482 are left unresolved by this legislation. Congress believed that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect.

In revising section 482, Congress did not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant development stages would be included. In order for cost-sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development. In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be provided to such party to reflect its investment.

Effective Date

Under the Act, the new provisions generally apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1985, or licenses granted after such date (or before such date with respect to property not in existence or owned by the taxpayer on such date). Congress intended to substitute August 16, 1986 for the November 16, 1985 date in the case of certain transfers not affected by the House bill.[20] No inference is intended as to whether the same result could nevertheless be reached under prior law for transfers prior to these effective dates.

For purposes of section 936, the new provisions apply to taxable years beginning after December 31, 1986, without regard to when any transfer (or license) was made.

Revenue Effect

This provision, apart from its application to possessions corporations, is estimated to increase fiscal year budget receipts by $24 million in 1987, $59 million in 1988, $82 million in 1989, and $108 million in 1990, and $137 million in 1991.

5. Compliance provisions applicable to U.S. persons resident abroad and green card holders (sec. 1234 of the Act and sec. 3405 and new sec. 6039E of the Code)[21]

Prior Law

U.S. citizens who live abroad are required to file U.S. tax returns and pay U.S. tax on their worldwide income, just as they are required to do when they live in the United States. In addition, it is possible for an alien to be considered a resident of the United States even during periods when he is living outside of the United States; such persons therefore continue to have the same duty to file and pay tax as any other U.S. citizen or resident. Certain special rules apply to U.S. citizens and residents who live abroad, such as Code section 911's limited exclusion of foreign earned income. In addition, credits against tax may be available to such persons for foreign taxes paid on their foreign source income.

Reasons for Change

Failure to file

Congress was concerned that a substantial percentage of U.S. persons resident overseas may fail to comply with the requirement that they file U.S. tax returns. The General Accounting Office has gathered evidence suggesting that the percentage of taxpayers who fail to file returns is substantially higher among Americans living abroad than it is among those resident in the United States. Such nonfilers may consist of two general types. First, there are negligent nonfilers: those who assume that their residence overseas exempts them from U.S. tax, and those who think that they need not file if section 911 and/or foreign tax credits eliminate their U.S. tax liability. Second, there are fraudulent nonfilers: those who know their duty to pay U.S. tax but do not fulfill it. Congress believed that both of these cases presented significant compliance problems that needed to be addressed.

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[20] H.R. 3838, as reported by the Committee on Ways and Means of the House of Representatives on December 7, 1985. A technical correction may be needed so that the statute reflects this intent.

[21] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 986(a) and (b); S.Rep. 99-313, pp. 389-91; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 638-40 (Conference Report).

With respect to the first case, the negligent nonfiler, Congress emphasized that it is important that a return be filed even by those who believe their U.S. tax liability to be zero (as long as their gross income exceeds the return filing threshold). The Internal Revenue Service should have the opportunity to determine that taxpayers with significant gross income have properly applied the provisions relevant to the determination of their liability. Since the foreign tax credit is among the most difficult provisions of the Code, it is particularly important that the Service have an opportunity to review the application of those provisions by citizens and residents abroad.

With respect to the second case, the fraudulent nonfiler, it is obviously important to the integrity of the Federal tax system that the government have the ability to detect and bring to justice those who evade their share of the tax burden.

Congress believed that both cases should be addressed by requiring that an Internal Revenue Service information return be completed in conjunction with the processing of applications for passports in the case of citizens, and permanent resident visas ("green cards") in the case of resident aliens. Such a requirement serves to notify inadvertent nonfilers of their continuing duty to file a U.S. tax return. Presumably a substantial number of such nonfilers will respond by filing their returns. In addition, of course, such a requirement provides the IRS with information that enables it to contact nonfilers and, if necessary, initiate collection actions. Congress recognized that the ten-year validity of passports means that such information will be collected only at infrequent intervals. Nevertheless, Congress believed that the occasional provision of such information would represent a substantial improvement over prior law, which provided the IRS with far fewer opportunities to obtain information concerning U.S. taxpayers living abroad. U.S. persons will no longer be able to move overseas and drop out of the U.S. tax system entirely; occasional reporting in conjunction with renewal applications ensures ongoing opportunities to locate such persons.

Collection of tax

Even when overseas nonfilers are identified, enforcement is often difficult because the IRS is rarely able to collect tax in a foreign country. The Service must instead attempt to locate assets within the United States which can be seized to satisfy a nonfiler's tax liability; if the nonfiler has taken most of his assets abroad, collection may be impossible.

Under prior law, pension payments were generally subject to withholding only at the taxpayer's election. Such payments often represent a substantial stream of income to U.S. persons resident overseas who are relatively likely to owe U.S. tax on such income (because the section 911 exclusion does not apply to it). Therefore, Congress believed that it was appropriate to require withholding with respect to pension payments to persons with foreign addresses absent a showing that withholding is not required.

Explanation of Provisions

Failure to file—IRS information returns

The Act provides that, notwithstanding any other provision of law, an IRS information return generally must be filed in conjunction with a citizen's passport application, and with a resident alien's green card application. These returns must provide the individual's taxpayer identification number (if any), any foreign residence of a passport applicant, information with respect to whether a green card applicant has been required to file a tax return for the individual's most recent three taxable years, and such other information as the Secretary may require. Congress expressed the expectation that the instructions accompanying these information returns would clearly explain the filing requirements applicable to citizens and residents living abroad.

To deter noncompliance, a new penalty of $500 generally applies with respect to each failure to file the required return, in addition to any other applicable penalties (such as the criminal penalties provided in section 7203 for willful failures to comply with the reporting and other requirements of the Code).

Notwithstanding any other provision of law, U.S. agencies which collect (or are required to collect) the new information returns must provide them, and the names (and any other identifying information) of any individuals who refuse to provide them as required, to the Secretary.

The Act authorizes the Secretary to exempt any class of individuals from the return requirements by regulations if he determines that applying the return requirements to those individuals is not necessary to carry out the provision's purposes.

Collection of tax—withholding on pension payments

The Act provides that pension benefits (and similar payments) are subject to withholding under section 3405 if delivered outside the United States. The election generally available under section 3405 to forego withholding is not available in such cases. This automatic withholding does not apply if the recipient certifies to the payor that he or she is not a U.S. person resident overseas (or a tax avoidance expatriate (sec. 877)). Congress expressed the expectation that such a certification might appropriately be provided for by modifying forms prescribed by the Secretary for the use of payees making the election to forego withholding under section 3405.

Effective Date

The reporting requirement applies to passport and green card applications submitted after December 31, 1987 (or, if earlier, the effective date of the initial regulations under the reporting requirement provisions, but not before January 1, 1987). The withholding requirement applies to payments made after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by less than $5 million per year.

6. Treatment of certain passive foreign investment companies (sec. 1235 of the Act and secs. 532, 542, 551, 851, 904, 951, 1246, and 6503 and new secs. 1291, 1293, 1294, 1295, 1296, and 1297 of the Code)[22]

Prior Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations generally are subject to U.S. taxation only on their U.S. source income and income from a U.S. business. Foreign corporations generally are exempt from U.S. taxation on foreign source income.

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on a U.S. shareholder of a foreign corporation only when the shareholder receives the foreign corporation's earnings in the form of a dividend. That is, a U.S. shareholder of a foreign corporation generally defers tax on that income until receipt of dividends.

The subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" or other activities conducted by corporations controlled by U.S. shareholders is taxed currently to the corporation's U.S. shareholders without regard to whether they actually receive the income currently in the form of a dividend. However, the subpart F rules applied under prior law only if more than 50 percent of the voting power in the foreign corporation was owned by U.S. persons each of whom owned (directly or indirectly) at least a 10-percent interest in the corporation. Moreover, even if ownership is so concentrated that the subpart F rules apply, the rules only apply to those U.S. persons who are considered to own (directly or by attribution) 10 percent or more of the voting power in the foreign corporation. Thus, a less than 10-percent shareholder in a controlled foreign corporation can avoid current recognition of income under these provisions.

Two other similar sets of rules, the personal holding company rules and the foreign personal holding company rules, also subjected foreign corporations or their U.S. shareholders to either a penalty tax or current taxation on passive investment income or futures trading income, but these rules applied only if five or fewer individuals owned (directly or indirectly) more than 50 percent in value of the stock of a foreign corporation. Thus, these provisions could be avoided by dividing ownership evenly between U.S. and foreign individuals (in the case of the foreign personal holding company rules) or by dispersing majority ownership among more than five individuals (in the case of either set of rules).

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[22] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 625; H.Rep. 99-426, pp. 406-412. H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 925; S. Rep. 99-313, pp. 392-399; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 640-645 (Conference Report).

Shareholder level tax on disposition

Code rules attempt to prevent U.S. shareholders of foreign corporations from repatriating earnings of those corporations at prior law's lower capital gains rates after deferring tax on those earnings. For example, gains derived by a U.S. person who is a 10-percent shareholder (at any time during a five-year period) in a controlled foreign corporation (as defined in the subpart F rules) on the disposition of that corporation's stock generally are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (Code sec. 1248). These rules allow, however, a corporate shareholder to claim an indirect foreign tax credit for its share of the foreign income taxes paid on those earnings by the controlled foreign corporation that are treated as a dividend to the shareholder.

However, section 1248's scope is limited. Wide dispersal of a foreign corporation's stock ownership can avoid controlled foreign corporation status. Even if the foreign corporation is controlled by U.S. shareholders, a less than 10-percent shareholder may dispose of his investment and potentially receive capital gain treatment for the increase in value of his investment.

Another provision, the foreign investment company provision (sec. 1246), was enacted in 1962 along with the subpart F rules to prevent U.S. investors from receiving capital gains treatment on disposition of their stock when U.S. ownership in the foreign corporation was widely dispersed but total U.S. ownership exceeded 50 percent and the foreign corporation primarily invested in securities. As amended, the provision generally applies under present and prior law to any foreign corporation that is either (1) registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust or (2) owned at least 50 percent by U.S. persons and engaged primarily in the business of investing or trading in securities (as defined in section 2(a)(36) of the Investment Company Act of 1940) or commodities or interests therein. In the latter case, a foreign investment company is considered to be 50 percent owned under this provision if 50 percent or more of its stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, the person is subject to ordinary income treatment to the extent of his share of the foreign investment company's post-1962 accumulated earnings and profits, but not to exceed the person's gain on the disposition.

Under prior law, it was unclear whether sections 1248 and 1246 could have applied to the same factual situation. For example, if a controlled foreign corporation had a 10-percent owner and the corporation was in the business of investing in securities, both provisions potentially applied in the event the 10-percent owner disposed of his or her stock. Under prior law, since an inclusion under section 1248 brought with it a deemed-paid credit for taxes paid by a foreign corporation but a section 1246 inclusion did not, the deemed-paid foreign tax credit was not available in such circumstances if section 1246 took priority.

Reasons for Change

Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. Since current taxation generally is required for passive investments in the United States, Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation. Congress further believed that the nationality of the owners of controlling interests of a corporation which invests in passive assets should not determine the U.S. tax treatment of its U.S. owners. In Congress' view, the absence of U.S. control did not necessitate preferential U.S. tax treatment to U.S. persons who invest in passive assets through a foreign corporation. Moreover, Congress recognized that U.S. persons who invested in passive assets through a foreign corporation obtained a substantial tax advantage vis-a-vis U.S. investors in domestic investment companies because they not only were able to avoid current taxation but also were able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income.

Although Congress believed current taxation was more appropriate than continuation of deferral of tax on income derived from passive assets, Congress recognized that current taxation of U.S. investors in passive foreign investment companies could create difficulties for certain investors in cases where the U.S. investors did not have the ability to obtain relevant information relating to their share of the funds' earnings and profits, did not have enough control to compel dividend distributions, or did not have sufficient liquidity to meet a current tax liability before actual income was realized from their investment. For these reasons, Congress considered it appropriate to adopt two taxing mechanisms. One provides for current taxation on the U.S. owners' shares of all of the company's actual income, subject to an election to defer payment of tax on that income until a distribution from the company or a disposition of the stock, with an appropriate interest charge. The other allows U.S. investors both to compute their income from the passive investment based upon certain reasonable assumptions and to delay payment of their tax liability until they actually realize cash from their investment through distributions or dispositions, provided that any such delayed tax payment is subject to an interest charge. In this regard, Congress intended that if current taxation were not required in all cases, then at least the economic equivalent of current taxation would be approached in all cases.

In those cases where Congress recognized that it would be difficult for U.S. investors who invest in foreign corporations to obtain sufficient information with which currently to compute their correct tax liability, Congress believed that attributing income over the holding period of the investment, together with the imposition of an interest charge, would eliminate the economic benefit of deferral without imposing an administrative burden on those U.S. investors and on the Internal Revenue Service. Congress also believed that using the highest statutory rate of tax for an investor in computing the deferred tax amount is appropriate because of the low top rates the Act provides.

Under prior law, a U.S. investor may never have been fully taxed on his or her share of a foreign investment company's accumulated earnings. Congress noted that if similar income were generated by a domestic investment company or was otherwise currently subject to U.S. tax, the U.S. investor would have been taxed on the full amount of the income. In Congress' view, if current taxation of a passive foreign investment company's actual income is required, U.S. investors should be taxed on their entire share of the company's earnings, regardless of whether the earnings are distributed. Similarly, in those cases where current taxation of a passive foreign investment company's actual income is required, Congress believed that it is appropriate to allow U.S. investors to receive flow-through treatment for their share of the company's capital gain income if the Internal Revenue Service has adequate access to the company's books and records.

Because the Act's provisions approximate the economic equivalent of current taxation, Congress did not believe that a passive foreign investment company should be subject to two penalty provisions contained in the Code: the accumulated earnings tax provision and the personal holding company tax provision. Congress believed that those penalty provisions generally were designed to prevent either the conversion of income from dividend income to capital gain income or the deferral of income or both, and that the Act reduces these concerns for corporations that are subject to the Act's new rules.

Explanation of Provision

Overview

The Act defines passive foreign investment companies (PFICs) and establishes a set of rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds", where the Act requires each U.S. shareholder to include currently in gross income his or her share of a PFIC's total earnings, with an election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders are required to pay tax on income realized from a PFIC and to pay an interest charge which is attributable to the value of deferral.

Definition of passive foreign investment company

General definition

A passive foreign investment company (PFIC) is defined by the Act to mean any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or any foreign corporation if 50 percent or more of the average value of its assets consists of assets that produce, or are held for the production of, passive income. For example, corporate stock generally is intended to be a passive asset for this purpose. Passive income generally is defined for these purposes to mean income that is includible in the new passive income separate foreign tax credit limitation provided in section 1201 of the Act (new Code sec. 904(d)(2)(A)), without regard to the exceptions contained therein (i.e., without regard to the exceptions to passive income for income included in other separate foreign tax credit limitations, export financing interest, high-taxed income, and foreign oil and gas extraction income). Thus, passive income generally includes dividends, interest and its equivalents, passive rents and royalties, annuities, gains from the disposition of stocks and securities and certain other assets, certain gains from commodity trading, and certain foreign currency exchange gains.

The Act excludes from the definition of a PFIC any foreign investment company described in Code section 1247 (i.e., foreign investment companies that made an election before 1963 to distribute their income currently).

Exceptions to passive income

Except as provided in regulations, passive income for this purpose does not include income derived by bona fide banks and insurance companies. Any foreign bank licensed to conduct a banking business under the laws of the United States or of any State generally is considered a bona fide bank for this purpose. Income of a bona fide insurance company that is not treated as passive income is that income which would be subject to taxation under subchapter L if the income were derived by a domestic insurance company. Congress believed that bona fide underwriters of securities would be excluded from classification as PFICs both under the asset test (because the majority of their assets, particularly securities held for sale to the public, are assets that do not give rise to subpart F FPHC income by virtue of the dealer exception in sec. 954(c)) and under the income test (because a substantial amount of their income is commission income, which is not subpart F FPHC income). The Act provides regulatory authority to expand the exception to passive income for income derived by a foreign bank licensed to do business in the United States to any other foreign corporation engaged in the active conduct of a banking business, as well.

As indicated, the Act provides regulatory authority to restrict the exception for income derived by bona fide banks and insurance companies where it is necessary to prevent U.S. persons from earning what is essentially investment income in a tax deferred entity. For example, Congress contemplated that regulations will be prescribed to provide circumstances where income derived by a bank licensed to do business in the United States is not automatically excluded from passive income. Further, it was intended that entities engaged in the business of providing insurance may derive passive income and, thus, qualify as PFICs in the event the entities maintain financial reserves in excess of the reasonable needs of their insurance business. Additionally, a foreign corporation established to acquire insurance coverage on behalf of related persons (a captive insurance company) may qualify as a PFIC in the event there is no shifting of risk to the foreign entity. In these captive arrangements, since there is no shifting of risk, the company is not an insurance company. The investment income generated by this captive-type company from its capital will be treated as passive income, thereby possibly subjecting the company to PFIC status. It is intended that income derived by foreign banks and other financial or insurance businesses that operate as incorporated investment vehicles on behalf of shareholders or other related parties be treated as passive income for purposes of these rules.

Exception for active businesses

Congress did not intend that foreign corporations that own subsidiaries primarily engaged in active business operations be treated as PFICs. To this end, the Act provides look-through treatment to classify these corporations. In determining whether a corporate shareholder is a PFIC, the Act attributes a proportionate part of a subsidiary's assets and income to the corporate shareholder. Under this look-through rule, amounts such as interest and dividends received from foreign or domestic subsidiaries are to be eliminated from the recipient's income in applying the Act's income test and the shareholder's stock investment is to be eliminated from its assets in applying the Act's asset test. For example, a foreign holding company that receives dividends or interest from a subsidiary is not treated as receiving passive income unless the subsidiary derives passive income. A corporation is a "subsidiary" of an upper-tier corporation for these purposes if at least 25 percent of the value of the corporation's stock is owned by the upper-tier corporation. It was intended that attribution be made to lower-tier corporations where 25 percent direct or indirect ownership is held and not only to a first-tier corporation.[23]

The Act further excludes from the definition of a PFIC a foreign corporation that receives passive income in its first year of operation but which engages in an active business following the start-up year, and a foreign corporation that would be a PFIC in the year following the cessation of an active business but which becomes active again in the year following the year in which it otherwise would be classified as a PFIC. The start-up exception provides that a foreign corporation is not considered a PFIC for the first year the corporation receives gross income if (1) no predecessor of the corporation was a PFIC; (2) the corporation satisfies the Secretary that it will not be a PFIC for either of the first two taxable years following the start-up year; and (3) the corporation is not in fact a PFIC for either of these years. The exception for existing corporations that change their active businesses provides that a corporation is not treated as a PFIC if (1) it (and all predecessors) was not a PFIC for any prior taxable year, (2) it establishes to the Secretary's satisfaction that substantially all of its passive income is attributable to proceeds from the disposition of one or more active businesses and it will not be a PFIC in any of the two taxable years after the current year, and (3) it is, in fact, not a PFIC for either of the two taxable years after the current taxable year.

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[23] A technical correction may be needed so that the statute reflects this intent.

General rule—nonqualified funds

General rule

The Act requires that U.S. shareholders in PFICs that are not "qualified electing funds" (defined below) pay U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or on receipt of an "excess" distribution (new Code sec. 1291). Under this rule, gain recognized on disposition of stock in a PFIC or on receipt of an "excess" distribution from a PFIC is considered to be earned pro rata over the shareholder's holding period of his or her investment. The U.S. tax due in the year of disposition (or in the year of receipt of an "excess" distribution) is the sum of (1) U.S. tax computed using the highest statutory rate of tax for the investor (without regard to other income or expenses the investor may have in those years) on the income attributed to the years of his holding period (other than the current year and other than years before the foreign corporation was a PFIC), plus (2) interest computed (using the rates and methods provided in sec. 6621) from the due date of the returns (without regard to extensions) for the years to which income is attributed to the due date of the return (without regard to extensions) for the year of disposition (or year of receipt) imposed on the deferred tax, plus (3) U.S. tax on the income attributed to the year of disposition (or year of receipt) and to the years in which the foreign corporation was not a PFIC that precede the year of disposition (for which no interest is due). This rule provides that all gain recognized on the disposition of PFIC stock and all excess distributions must be treated as ordinary income. The portions of distributions that are not characterized as "excess" distributions are, of course, subject to tax in the current year under general Code rules.

The Act provides that distributions from nonqualified funds are not eligible for a deemed paid foreign tax credit under section 902. For purposes of claiming any withholding tax as a foreign tax credit, however, the total amount of the distribution, including any "excess" distribution amount, is included in gross income in the year of receipt. In claiming a foreign tax credit in the year of receipt of an excess distribution, the amount of any withholding tax may be applied against, for example, the total amount of deferred tax and interest computed on the excess distribution and the amount of tax computed on the distribution that is attributed to the current year and any pre-PFIC years.

Definition of excess distribution

The Act defines an "excess" distribution as any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the three preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year).

The determination of an excess distribution can be illustrated in the following example: assume an investor acquires 1000 shares of stock in a PFIC on January 1, 1987, and 1000 shares of stock in the PFIC on January 1, 1988. The PFIC uses a calendar year as its taxable year. Further assume that on December 31, 1987, the investor receives a distribution of $500; on December 31, 1988, the investor receives $1000, and on December 31, 1989, and December 31, 1990, the investor receives $1000. Finally, assume that on April 1, 1991, the investor receives $1,500 and on October 1, 1991, the investor receives $500. Under the Act, none of the distributions received prior to 1991 are excess distributions since the amount of each distribution with respect to a share of stock is 50 cents. With respect to the distributions received during 1991, however, the total distribution with respect to each share of stock is $1 such that the total excess distribution with respect to each share of stock is 37.5 cents ($1 minus (1.25 times 50 cents)).

Accordingly, the total excess distribution for the PFIC taxable year ended December 31, 1991 is $750 (37.5 cents per share times 2,000 shares). This excess distribution must be allocated ratably between the two distributions during the PFIC's taxable year. Thus, $562.50 (75 percent of the excess distribution) is allocated to the April 1, 1991 distribution and $187.50 is allocated to the October 1, 1991 distribution. These amounts are then ratably allocated to each block of stock outstanding on the relevant distribution date. For the distribution on April 1, 1991, $281.25 of the excess distribution is allocated to the block of stock acquired on January 1, 1987 and $281.25 is allocated to the block of stock acquired on January 1, 1988. The $187.50 excess distribution on October 1, 1991 is also divided evenly between the two blocks of stock outstanding on the date of the distribution. The excess distribution is finally allocated over the relevant holding period of each block of stock as provided in section 1291(a)(1).

The Act provides that regulations are to be prescribed making proper adjustments for stock splits and stock dividends, determining the amount of excess distributions in cases where investments are acquired or disposed of at varying times in a taxable year, determining the excess distribution amount when distributions are received in currencies other than the U.S. dollar, and aggregating stock ownership for shares with the same holding period.

Anti-avoidance rules

The Act generally incorporates the anti-avoidance rules in present and prior law section 1246 (relating to foreign investment companies) and applies these rules to U.S. persons who hold stock in nonqualified funds. These rules (1) require stock with a substituted basis to inherit the attributes of PFIC stock, (2) require stock held in certain entities which are not PFICs but which own PFIC stock to be treated as PFIC stock, (3) deny a basis step-up for PFIC stock acquired from a decedent (other than from a foreign decedent), and (4) require 5 percent owners of PFICs to report certain information required by the Secretary.

The Act also provides the Secretary the authority to disregard any nonrecognition provision of present and prior law on dispositions of PFIC stock. For example, regulations may treat a gift of stock in a nonqualified fund to a non-taxpaying entity, such as a charity or a foreign person, as a disposition for purposes of those rules in order that the deferred tax and interest charge attributable to that stock not be eliminated.

Qualified electing funds

General rule

For any U.S. investor whose PFIC agrees to supply appropriate information to the IRS, the Act provides a current taxation system: every U.S. person who owns stock in a "qualified electing fund" must include currently in gross income his or her pro rata share of the PFIC's total earnings and profits. This inclusion rule requires current payment of tax, absent a shareholder-level election to defer tax (as described below). Amounts currently included in income are added to an investor's stock basis, and amounts distributed that have previously been included in income decrease an investor's stock basis. The Act provides that if an investor provides to the Secretary's satisfaction that amounts distributed have been previously included in his or her income, then these amounts may be treated as nontaxable distributions. The amount currently included in income is divided between an investor's pro rata share of the ordinary income of a PFIC and net capital gain income of a PFIC. The characterization of income and the determination of earnings and profits are intended to be made pursuant to general Code rules. The Act provides that U.S. corporate shareholders which own 10 percent of a PFIC are able to claim an indirect foreign tax credit for their share of the foreign income taxes paid by the PFIC.

Election to defer current payment of tax

The Act provides that U.S. investors in qualified electing funds may, subject to the payment of interest, elect to defer payment of U.S. tax. This election is available only for the U.S. tax attributable to the amounts currently included in income but for which no current distributions are received. An election to defer tax is not available, however, if any amounts are required to be currently included in income under the foreign personal holding company (FPHC) rules (sec. 551) or the subpart F rules (sec. 951). An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest.

Under the Act, certain events cause an extension of time to pay tax on undistributed earnings to terminate. First, any distribution from a PFIC that includes earnings for which an extension to pay tax was made terminates that extension. Second, any disposition of stock in a PFIC terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. Further, all extensions of time to pay tax on earnings attributable to all stock held in a PFIC terminate if the PFIC ceases to be a qualified electing fund, or if the corporation ceases to be a PFIC. Any event which terminates an extension causes the deferred tax and interest to be payable on the due date of the investor's tax return (without regard to extensions) for the year in which the termination occurs. A shareholder may, of course, pay any deferred tax and interest prior to a distribution or disposition. Disposition for this purpose is intended to mean any transfer of ownership, regardless of whether the transfer constitutes a realization or recognition event under general Code rules. For example, a transfer at death or by gift of stock of a qualified electing fund is to be treated as a disposition for these purposes.

Definition of qualified electing fund

The Act defines a "qualified electing fund" as any PFIC which properly elects with the Secretary and which complies with the requirements the Secretary prescribes to determine the ordinary income of the fund and its capital gain income, to ascertain its stock ownership, and to ascertain any other information necessary to carry out the purposes of these rules. It is anticipated that the Internal Revenue Service will require the reporting of information similar to that required of domestic investment companies, such as U.S. investors' pro rata shares of a fund's ordinary income and capital gain income, based on U.S. tax principles. It is also anticipated this information reporting will be limited to U.S. investors. Verification of investors' tax status (i.e., as a U.S. person or a foreign person) in the fund will also be required in the manner prescribed by the Secretary.

Election to be qualified electing fund

The election to be a qualified electing fund for any taxable year must be made before the 15th day of the third month of the taxable year following the year for which the election is being made. Once an election is made, it continues until the year the corporation ceases to be a PFIC or the year the election is revoked with the consent of the Secretary. Congress intended that revocation be granted only in circumstances where compliance with the Act's provisions is assured. It was not intended that a fund that intentionally fails to meet its compliance obligations will revoke its qualified electing fund election. As indicated above, any revocation, or the loss of PFIC status, will, however, cause all prior extensions of time to pay tax to terminate and will cause the investor to be subject to the deferred tax and interest charge rules of section 1291 on eventual disposition of his or her stock.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds

Gain recognized on disposition of stock in a PFIC by a U.S. investor is not taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986 and which include any portion of the investor's holding period. This provision allows any unrealized appreciation in the stock of a qualified electing fund to be taxable as capital gain income (if the stock is a capital asset) and without the imposition of an interest charge.

Distributions received from a PFIC in a year the PFIC is a qualified electing fund are also not taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986, and which include any portion of an investor's holding period.[24] This provision prevents a fund from retaining its annual income, electing to be a qualified electing fund in a subsequent year, and then distributing the accumulated income without the imposition of an interest charge.

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[24] A technical correction may be needed so that the statute reflects this intent.

Any U.S. shareholder who owns stock in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxable year may elect to be taxed on the unrealized appreciation inherent in his or her PFIC stock up through the first day of the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment. Thereafter, the shareholder will be taxed under the rules applicable to qualified electing funds. Absent this election, U.S. investors will be taxed under both the provisions applicable to qualified electing funds and section 1291, and will, consequently, pay deferred tax and interest not only on gain attributable to the years in which the PFIC is not a qualified electing fund but also on gain attributable to the period during which an investor is taxed currently on his or her share of a PFIC's earnings.

Time for determination of PFIC status

The Act provides that a shareholder in a PFIC which is not a qualified electing fund is treated as holding stock in a PFIC if at any time during his or her holding period the corporation was a PFIC. Consequently, on disposition of stock in a corporation which is a PFIC in the year of disposition or was previously a PFIC at some time when the shareholder held the stock, any gain on the disposition of the stock will be subject to the deferred tax and interest charge rules of section 1291. The Act allows, however, a shareholder to purge his or her stock of its classification as PFIC stock if the corporation ceases to be a PFIC in a subsequent taxable year and if the shareholder elects to recognize gain in the amount of the unrealized appreciation of the shareholder's stock through the close of the year in which the corporation ceases to be a PFIC and pays all prior deferred tax and interest.

For a fund that was a qualified electing fund for all of its years, the Act provides that stock in a PFIC automatically ceases to be classified as PFIC stock when the foreign corporation ceases to be a PFIC. As indicated above, a consequence of a corporation ceasing to be a PFIC is that all prior elections to defer payment of tax and interest by all U.S. investors in the PFIC terminate and, thus, the investors are required to pay all prior deferred tax and interest.

Attribution of ownership

In determining stock ownership, a U.S. person is considered to own his or her proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary (or, in certain cases, grantor), or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock. However, if a U.S. person owns any stock of a foreign corporation which is also a PFIC, the person is considered to own his proportionate share of any PFIC stock owned by the foreign corporation, regardless of the percentage of his or her ownership of the foreign corporation. In attributing stock ownership, the Act does not treat a U.S. person who is considered to own stock of another entity as actually owning the stock of the entity for purposes of reattributing the stock to another person, except to the extent provided in regulations. It may be necessary in the case of a U.S. partnership for regulations to treat stock considered to be owned by the partnership as actually owned by the partnership so as to attribute the stock to the partnership's partners. In attributing stock owned by a trust, it is intended that the general rules of subchapter J apply. That is, in the case of a grantor trust, any stock owned by the trust generally shall be attributed to the grantor of the trust, and any stock owned by a trust which is not a grantor trust shall be attributed to the beneficiaries of the trust.

Anti-avoidance rules

The Act provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act's provisions and to prevent circumvention of the interest charge.

As an example where regulations may be required, the ownership attribution rules of the Act attribute the ownership of PFIC stock (in the event of an intervening corporation) only to a U.S. person that owns 50 percent of the intervening corporation. A foreign corporation engaged in an active trade or business generally will not be a PFIC. If such a corporation issues a separate class of stock and uses the proceeds to invest in a PFIC or to invest directly in passive assets, the corporation will still probably not be a PFIC under the general definition. However, in these instances, it may be necessary for regulations to treat the separate class of stock as a separate corporation for this purpose. In that event, the separate corporation will in all likelihood be a PFIC and the attribution rules will attribute any lower-tier PFIC stock to the ultimate U.S. investors.

Another instance where regulations may be necessary to carry out the purposes of the Act's provisions is where the ownership attribution rules attribute stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. Congress intended, however, that regulations treat the disposition of interests in the intervening entity as a disposition of the PFIC stock in appropriate cases. Similarly, if necessary to avoid circumvention of the Act's interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.

For purposes of the Act, a person is treated as disposing of his or her stock in a PFIC if the stock is used as security for a loan.

Coordination with other current inclusion and disposition rules

The Act adopts rules to coordinate the PFIC provisions with the subpart F and FPHC current inclusion rules in the case of qualified electing funds. Under these coordination rules, amounts required to be included in income currently under either section 951 or 551 shall be included first under those rules and then any additional amounts shall be included currently under section 1293. It was intended that if income is included currently by a U.S. person under the subpart F provisions and the foreign corporation is also a PFIC which is not a qualified electing fund, the amounts previously included in income under that provision should not also be subject to the Act's interest charge rules on subsequent receipt of an excess distribution or on subsequent disposition of stock.[25]

Under the Act, if stock in a PFIC which is also a foreign investment company under section 1246 is disposed of, the Act's PFIC provisions apply and section 1246 does not apply to the earnings and profits of the company for any taxable year beginning after 1986. Accordingly, if the PFIC is a qualified electing fund for all of its years of existence, any gain recognized on a disposition of the PFIC stock will be treated as gain from the disposition of a capital asset if the stock is a capital asset in the hands of the shareholder, except to the extent the gain is attributable to pre-1987 years' earnings and profits. If the PFIC is not a qualified electing fund for all of its years of existence, or if the election to recognize gain by the shareholder at the time the PFIC became a qualified electing fund was not made, any gain will be treated as ordinary income and will be subject to the deferred tax and interest charge rules of section 1291. If stock in a PFIC which is not a qualified electing fund but which is also a controlled foreign corporation is disposed of, the Act's PFIC provisions apply, not section 1248, to the earnings and profits of the company. Further, if stock in a foreign investment company which is also a controlled foreign corporation but is not also a PFIC is disposed of, prior law section 1246 is amended to provide in these circumstances that the gain is to be taxed under section 1248 in the case of 10-percent corporate shareholders.

Other rules

The Act further provides that PFICs are not to be treated as personal holding companies or to be subject to the accumulated earnings tax.

PFIC inclusions are also resourced as U.S. source if the PFIC is a United States-owned foreign corporation (under sec. 904(g)) and the PFIC receives U.S. source income.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1986.

The Act provides that pre-effective date earnings of foreign corporations that become PFICs under the Act are to be taxed as under prior law, but only with respect to the Act's interest charge provision. For example, assume that a U.S. person has owned stock in a foreign corporation since January 1, 1984. The corporation is a PFIC under the Act but is not a qualified electing fund. The U.S. person disposes of his stock on December 31, 1988, at a gain of $1000. The income that is attributed to years 1984-1986 ($600) will not be subject to the interest charge. However, all of the gain will be treated as ordinary income.

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[25] A technical correction may be needed so that the statute reflects this intent.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $10 million in 1987, $17 million in 1988, $16 million in 1989, $18 million in 1990, and $20 million in 1991.

E. Treatment of Foreign Taxpayers

1. Branch profits tax (sec. 1241 of the Act and secs. 861 and 906 and new sec. 884 of the Code)[1]

Prior Law

Under prior law, the United States sought to tax dividends and interest paid by foreign corporations most of whose operations were in the United States generally in the same manner as dividends and interest paid by U.S. corporations that operated in the United States. If the recipient of the dividends or interest was a U.S. person, the United States imposed tax on the dividends or interest at the regular graduated rates. If the recipient of the dividends or interest was a foreign person, however, symmetry was more difficult to achieve.

Under present and prior law, a U.S. corporation that pays dividends to a foreign person not engaged in a trade or business in the United States generally must, in the absence of a contrary treaty provision, withhold 30 percent of the payment as a tax. The United States imposes the tax at a flat 30-percent rate because generally it is not feasible to determine and collect a tax on net income from foreign persons who have limited tax contacts with the United States. Similarly, a 30-percent withholding tax applies to some interest paid to foreign persons, including interest paid to related parties and certain interest paid to banks. U.S. income tax treaties often reduce or eliminate the tax on interest paid to residents of the treaty country and reduce the tax on dividends paid to treaty residents to as little as 5 percent.

Similarly, under prior law, a foreign corporation, most of whose operations were in the United States, that paid dividends or interest (of the types taxable if paid by a U.S. corporation) to a foreign person had to withhold U.S. tax on a portion of the payments. A foreign corporation became liable to withhold only when more than half of its gross income for the prior 3 years was effectively connected with a U.S. trade or business. If the 50-percent threshold was crossed, the 30-percent (or lower treaty rate) tax applied to the allocable portion of the payment attributable to income of the foreign corporate payor that was effectively connected with its U.S. trade or business. One function of this withholding tax was to treat payments by foreign corporations with U.S. operations like payments by U.S. corporations.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 651; H. Rep. 99-426, pp. 431-435; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 951; S.Rep. 99-313, pp. 400-407; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 646-650 (Conference Report).

Reasons for Change

A U.S. corporation owned by foreign persons is subject to income tax on its profits. In addition, its foreign shareholders are subject to tax (collected by withholding) on the dividends which they receive (30 percent by statute, but frequently reduced to a lesser amount by treaty). Similarly, in certain circumstances interest payments made by a U.S. corporation to foreign creditors (including related foreign creditors) are subject to a U.S. withholding tax (30 percent by statute, in the case of interest paid to related parties and in the case of certain other interest, but frequently reduced or eliminated by treaty). Under prior law, no comparable shareholder-level taxes were imposed by the United States on the distributed profits or remitted interest of a U.S. branch of a foreign corporation (except in the limited case of a U.S. branch of a foreign corporation engaged in the commercial banking business).

Where a foreign corporation conducted its U.S. operations through a U.S. branch, the withholding taxes of prior law were designed to operate like the dividend and interest withholding taxes that would have applied had the U.S. operations been conducted through a separately incorporated U.S. subsidiary. However, under prior law, the withholding taxes applied only when a majority of the income of the foreign corporation was derived from its U.S. operations. Thus, a foreign corporation that derived a substantial amount of U.S. income but also operated extensively in other countries may not have been liable for the withholding taxes. Dividend and interest payments by U.S. corporations, on the other hand, were always subject to two levels of tax unless exempt by treaty or eligible for special Code exemptions, such as that for portfolio interest. Congress was concerned that these disparities arising under prior law provided an unintended advantage to U.S. branches of foreign corporations vis-a-vis their U.S. corporate competitors.

In addition, Congress was informed that it was often difficult to know when the taxes were due, and if they were due, it was difficult to enforce their collection by a foreign corporation. This was because the imposition of the withholding taxes was dependent on a foreign corporation deriving a certain percentage of its total income from a U.S. business, and because the taxes were imposed on payments by foreign corporations to foreign persons who often had no contact with the United States.

Congress believed that the disparity between the taxation of U.S. corporations owned by foreign persons and the taxation of U.S. branches of foreign corporations should be reduced. In Congress' view, a foreign corporation doing business in the United States generally should be subject to the same substantive tax rules that apply to a foreign corporation operating in the United States through a U.S. subsidiary. Congress noted that there were corporate and shareholder levels of tax for U.S. corporations owned by U.S. persons and for U.S. corporations owned by foreign persons. It was Congress' understanding that nearly all foreign corporations with branches in the United States avoided liability for the withholding taxes (if not otherwise avoided because the corporations were established in one of many countries with a tax treaty with the United States that precluded the United States from imposing its taxes) because their U.S. income was kept beneath the 50-percent threshold. Congress, therefore, concluded that prior law's 50 percent business income threshold was too high.

Congress further believed, however, that simply reducing prior law's business income threshold for applying the withholding taxes would not eliminate the disparity in treatment of U.S. branches of foreign corporations and U.S. subsidiaries of foreign corporations. Congress did not believe that U.S. jurisdiction over outbound payments should depend only on whether the amount of business conducted in the United States rose to some predetermined level.

To reduce the disparity in U.S. tax treatment of U.S. corporations and foreign corporations that operate in the United States, Congress believed that a tax on a branch's profits should be enacted. In Congress' view, a tax imposed on the branch profits of a foreign corporation is an appropriate substitute for the shareholder-level tax that applies to U.S. subsidiaries of foreign corporations. In Congress' view, the tax will reduce the disparity in the tax treatment of foreign corporations doing business in the United States through a U.S. branch and a U.S subsidiary, even where the foreign corporation is owned by U.S. persons. An example illustrates the results that occur when a foreign corporation is owned by U.S. persons. Assume that a U.S. corporation is wholly owned by a foreign corporation that is in turn wholly owned by a U.S. corporation. Income of the lower-tier U.S. corporation is subject to U.S. corporate tax. Dividends from the lower-tier U.S. corporation are subject to U.S. withholding tax when distributed to the foreign corporation. Dividends from the foreign corporation are subject to U.S. net tax when distributed to the ultimate U.S. parent (subject to the availability of the dividends received deduction). The United States allows no credit for the U.S. withholding tax imposed earlier. Under the Act, a similar result occurs with respect to a U.S. branch of a foreign corporation that is wholly owned by a U.S. corporation. Income of the U.S. branch of the foreign corporation is subject to U.S. corporate tax. The branch tax applies to profits remitted from the U.S. branch to the foreign corporation. As in the case of a U.S. subsidiary of a foreign corporation, described above, dividends from the foreign corporation are subject to U.S. net tax when distributed to the ultimate U.S. parent (subject again to the availability of the dividends received deduction). Again, there is no credit for the U.S. tax imposed earlier (in this case the branch tax rather than the withholding tax).

Moreover, Congress believed that the branch tax would be easier to administer than the prior law withholding tax on dividends and it will not depend for its application, as that tax does, on the foreign corporation's U.S. income exceeding an arbitrary threshold.

With respect to a tax on interest, it was Congress' view that a deduction allowed against gross U.S. effectively connected income generally should give rise to an inclusion subject to U.S. tax, without regard to the level of business conducted in the United States. The imposition of U.S. tax on interest payments of a U.S. branch and on interest deducted was also in Congress' view consistent with a branch profits tax and with the treatment accorded U.S. corporations that pay interest to foreign persons.

Congress recognized the value of U.S. income tax treaties for U.S. persons engaging in international commerce. Congress further recognized that most U.S. income tax treaties in force were not negotiated to allow the United States to impose a branch profits tax because the United States did not impose such a tax at the time of negotiation. Although Congress generally believed that a branch profits tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders, it understood that most treaty nondiscrimination articles relating to permanent establishments arguably operate to consider corporations and their shareholders separately in determining whether discriminatory tax rules exist. Congress generally did not intend to override U.S. income tax treaty obligations that arguably prohibit imposition of the branch profits tax even though as later-enacted legislation the Act's branch tax provisions normally would do so. Congress adopted this position, however, only on the understanding that the Treasury Department will renegotiate outstanding treaties that prohibit imposition of the tax.

Congress was, however, concerned that foreign investors resident in one country would attempt to use another country's tax treaty with the United States to avoid the branch profits tax and branch-level interest tax (i.e., they would treaty shop). In these cases, Congress believed such use of treaties to be improper. Congress generally held this view whether or not a third-country investor would have been entitled to treaty benefits had the investor made a direct U.S. investment since the United States is not certain, when an intervening entity in a second country is used to make an investment, if a residence country tax will be imposed on U.S. source income from the investment. The United States has particular reason to believe that there will be no residence country tax when a third-country investor routes U.S. investments through a low-tax jurisdiction. It was Congress' view that the United States should generally forego source basis taxation of dividends and interest only when residents of the treaty partner are taxed in the treaty country on this income. In cases of treaty shopping, then, Congress intended the Act to override conflicting provisions in U.S. treaties.

Explanation of Provision

Overview

The Act imposes branch-level taxes on profits of foreign corporations operating businesses in the United States and on interest paid or deducted by U.S. businesses operated by foreign corporations. The Act also reduces the U.S. business threshold that triggers the withholding tax on dividends paid by foreign corporations (applicable where the branch profits tax cannot be applied).

Branch profits tax

The Act imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount." The "dividend equivalent amount" is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected (or treated as effectively connected) with a U.S. trade or business, subject to two adjustments (detailed below). Thus, for example, the branch profits tax applies to income treated as effectively connected by section 897.[2] The Act's determination of effectively connected earnings and profits is made without reduction for dividend distributions made by a foreign corporation during a year, so that tax is imposed on a foreign corporation that has current earnings (which are not reinvested in a branch's trade or business, as provided below) even though the corporation may have made shareholder distributions.

The Act excludes from the imposition of branch profits tax the following earnings and profits attributable to income effectively connected with a U.S. trade or business: (1) certain earnings derived by foreign sales corporations (earnings attributable to income described in secs. 921(d) and 926(b)); (2) earnings derived by foreign transportation carriers that are exempt from U.S. tax by reciprocal exemption; (3) earnings derived from the sale of any interest in U.S. real property holding corporations; (4) earnings derived by corporations satisfying certain ownership and income requirements that are organized in certain U.S. possessions (corporations described in sec. 881(b)); and (5) earnings derived by certain captive insurance companies that are treated as deriving income effectively connected with a U.S. trade or business solely because of a special election (*see* sec. 1221(b)(2) of the Act).[3] The exclusion for earnings derived by corporations organized in certain U.S. possessions is intended to be "mirrored" so as not to apply the branch tax to U.S. corporations operating in possessions of the United States.

The Act provides that in arriving at the dividend equivalent amount a branch's effectively connected earnings and profits are adjusted in two circumstances. These adjustments identify changes in a branch's U.S. net equity (the difference between a branch's assets and liabilities treated as connected with its U.S. trade or business) that reflect profit remittances during a taxable year. The first adjustment to the dividend equivalent amount reduces the tax base to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). This reduction is measured by the increase in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year and (2) the excess of the money and adjusted basis of its assets over its liabilities at the end of the preceding year. The second adjustment increases the tax base to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation. This adjustment is measured by the reduction in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the preceding year and (2) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year. The Act provides that the increase in the tax base on account of a decrease in U.S. net equity is limited to the amount of prior earnings that has not been remitted to the home office. It was intended that this limitation equal the earnings and profits of the branch accumulated after the effective date that have not been remitted to the home office.[4] Thus, unless a branch has current earnings, no branch tax will be due if a branch has a post-1986 accumulated deficit.

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[2] This is the case without regard to whether the corporation earning the income has made an election under section 897(i) to be treated as a U.S. corporation. Since the election under section 897(i) is effective only for purposes of sections 897, 1445, and 6039C, this election does not result in the corporation being treated as a U.S. corporation for branch profits tax purposes.

[3] Thus, earnings attributable to income that is related person insurance income within the meaning of section 953(c)(2) and that is effectively connected without regard to the election under section 953(c)(3)(C) are not excludable from the branch profits tax base.

The Act provides that, in measuring the changes in U.S. net equity during a taxable year, the adjustments to a branch's effectively connected earnings and profits are to account for only the assets and liabilities that are treated as connected with the conduct of the branch's U.S. trade or business. The determination of these assets and liabilities is to be consistent with the rules used in allocating deductions for purposes of computing taxable income. It was intended that these assets and liabilities include only those assets that generate income taxable by the United States on a net basis and those liabilities that generate expenses which are allocable to income taxable by the United States on a net basis. For example, assets that generate effectively connected income which may be taxed by the United States (*i.e.*, the income is not treaty protected) are to be treated as connected with the conduct of a U.S. trade or business.

Since the taxable base is determined on the basis of effectively connected earnings and profits, the computation of U.S. net equity likewise is based on the earnings and profits value of the branch's assets and liabilities connected with its trade or business (if these values are different from the assets' and liabilities' adjusted tax bases). For example, in computing an increase or decrease in U.S. net equity, a branch that claims accelerated depreciation on its assets for the purpose of calculating taxable income will be required to make its branch-level tax computation using the assets' bases for earnings and profits purposes.

Congress intended that a branch's effectively connected earnings and profits be measured pursuant to general Code rules but be limited to amounts attributable to the branch's activities. For example, tax-exempt interest received or accrued by a branch is included in the branch's earnings and profits even though that amount is not included in the branch's effectively connected income.

Since the branch profits tax is imposed on earnings and profits effectively connected or treated as effectively connected with a U.S. trade or business, the tax applies, for example, to foreign corporations that are partners in a partnership which has a U.S. trade or business and to foreign corporations that own vessels and aircraft which generate income effectively connected with a U.S. trade or business (unless the income is not subject to U.S. tax because of a reciprocal exemption or a U.S. tax treaty). The branch profits tax also will apply to, for example, a foreign corporation that has made an election under section 882(d) to treat its real property income as effectively connected with a U.S. trade or business.

The rate of tax imposed by the Act on the dividend equivalent amount is 30 percent. However, in certain cases, this rate may be reduced by a U.S. income tax treaty. First, if an income tax treaty between the United States and the country in which a corporation is a resident (as defined below) permits imposition of a branch profits tax, but reduces the rate, the lower treaty rate applies, unless the corporation is treaty shopping. In treaty shopping cases, the 30-percent rate applies. Second, if a treaty between the United States and the country in which a corporation is a resident does not prohibit a branch profits tax but does not specify a rate at which the tax may be imposed, the treaty's direct investment dividend rate is to apply to the dividend equivalent amount, unless the corporation is treaty shopping in which case the 30-percent rate applies. Further, if a treaty between the United States and the country in which a corporation is a resident permits a branch profits tax, but provides a different computation from the one that the Act provides, or subjects the branch tax to other limitations not in the statute, the Act provides that the tax will apply subject to the treaty's computational provisions and other limitations, unless the corporation is treaty shopping in which case the treaty does not restrict the Act's provisions. For example, Congress understood that the U.S.-Canadian treaty allows a branch profits tax but that the tax is computed under rules different from the Act's rules; if a Canadian corporation which has a permanent establishment in the United States is not treaty shopping, the provisions of the U.S.-Canadian treaty apply in determining the branch tax payable by the Canadian corporation to the United States.

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[4] A technical correction may be needed so that the statute reflects this intent.

Branch-level interest tax

The Act provides that interest paid by a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision. It was intended that where this interest is paid to a U.S. person or a U.S. trade or business of a foreign person, the interest is also to be treated as U.S. source but not subject to withholding since it is subject to tax on a net income basis in the hands of the recipient.[5] To the extent a U.S. branch of a foreign corporation has allocated to it under Treasury Regulation section 1.882-5 an interest deduction in excess of the interest actually paid by the branch (this generally occurs where the indebtedness of the U.S. branch is disproportionately small compared to the total indebtedness of the foreign corporation), the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary (the U.S. branch, in actuality) from its foreign corporate parent (the home office). This excess is also subject to the 30-percent tax, absent a specific Code exemption or treaty reduction. The Act treats the excess interest as paid on the last day of a corporation's taxable year and provides that any U.S. tax due is payable by the foreign corporation within the time prescribed for filing the corporation's U.S. income tax return (not including extensions).

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[5] Technically, this provision only applies for purposes of sections 871, 881, 1441 and 1442. A technical correction may be needed so that the statute reflects Congress' intent that the provision apply for all purposes.

Under the general regulatory authority provided under the Act, the Secretary is to determine, for purposes of any special Code treatment, how the excess interest is to be treated. For example, the regulations may provide that where indebtedness of the home office is attributed to the branch, the excess interest is to be treated as incurred on each type of external borrowing by the corporation and determined by reference to the relative principal amount of, and the average interest rate on, each type of external borrowing. Thus, for example, in the case of a bank, the excess interest will not necessarily be treated as paid on a bank deposit. Congress was aware that some corporations attempt to establish actual debtor-creditor relationships for funds between a branch and a home office or between one branch and another. Congress recognized that the status of such arrangements is open to question from a tax perspective since only one legal entity is involved. Nonetheless, if companies are able to legally establish such relationships, it is intended that the regulations address these relationships and possibly treat the excess interest as incurred on each type of interbranch "loan". Congress was concerned that taxpayers may artificially structure interbranch loans in a manner different from their external liabilities in an attempt to reduce or eliminate the tax on excess interest. Congress expected the regulations to address this concern.

For purposes of determining whether the tax on the excess interest is to be reduced or eliminated by treaty, the applicable income tax treaty is the one between the United States and the country of the corporation's home office. Any treaty benefits available in this case are, however, subject to the Act's prohibition against treaty shopping. In the case of U.S. withholding tax on interest actually paid by a branch to a foreign recipient, the appropriate treaty will be that between the United States and the country of the recipient, subject again to the prohibition against treaty shopping.

Application of these rules to current U.S. treaties will, however, have to take into account differences among the treaties. For example, of the U.S. income tax treaties currently in force, older ones generally prevent or limit imposition of U.S. tax on interest paid by corporations resident in those treaty countries. These treaties do not permit the United States to impose tax on interest arising from and borne by U.S. permanent establishments. The Act does not override such treaties except in cases of treaty-shopping. Absent treaty shopping, these treaties will determine the U.S. taxability of excess interest of, or interest paid by a U.S. branch of, a foreign corporation.

More recent treaties, on the other hand, do permit the United States to impose tax on interest arising from and borne by U.S. permanent establishments. These treaties generally allow U.S. taxation of the interest made taxable by the Act. When one of these treaties applies, interest paid by the U.S. permanent establishment is taxable unless paid to a treaty-protected recipient (who is not treaty shopping) and excess interest is taxable at the treaty interest rate unless the foreign corporation itself is treaty shopping.

Relationship with tax treaties

In general, the Act's branch profits tax and branch-level interest tax do not apply where their application would be inconsistent with an existing U.S. income tax treaty obligation. Congress understood that it is the Treasury Department's interpretation that if a corporation is organized in a country with which the United States has a treaty that contains a nondiscrimination article similar to the article contained in the United States 1981 Model Income Tax Treaty, such article prohibits the Act's branch profits tax.

The Act provides, however, that the branch profits tax is to yield to treaties only in two cases. The first case is where a foreign corporation with a U.S. branch is a "qualified resident" of a treaty country (i.e., the corporation is not treaty-shopping) and the treaty prohibits the branch profits tax. The second case is where a foreign corporation resides in a country whose treaty permits the United States to impose its withholding tax on dividends paid by the corporation but otherwise prohibits the branch profits tax, whether or not the foreign corporation is treaty shopping. In this second case, however, the foreign corporation paying the dividends cannot claim any treaty benefits (i.e., reduced rates) with respect to the dividends if it is treaty shopping. The Act also prohibits any foreign corporation that receives a dividend from another foreign corporation from claiming any treaty benefits if the recipient is treaty shopping.

The Act provides that a foreign corporation is treaty shopping in two cases: First, treaty shopping occurs if more than 50 percent (by value) of the stock of the foreign corporation is owned (determined by looking through corporations, partnerships, estates, and trusts to ultimate individual ownership) by individuals who are not residents of the treaty country. U.S. citizens and resident aliens are treated as residents of the treaty country for this purpose.

Second, where 50 percent or more of a foreign corporation's income is used to meet liabilities to persons who are not residents of the country in which the corporation is a resident or of the United States, then the corporation is treaty shopping (a "base erosion" rule). This latter rule is used in many recent U.S. income tax treaties. It was Congress' view that its addition was necessary to prevent nonresidents of a treaty country from gaining treaty benefits.

The Act provides that if a foreign corporation's stock is primarily and regularly traded on an established securities market in the country under whose treaty it claims benefits as a resident, then the corporation is considered a qualified resident of that country. The Act also provides that if a foreign corporation's parent is organized in the same country as its subsidiary corporation, and the parent corporation's shares are primarily and regularly traded on an established securities market in that country, then the subsidiary corporation is considered a qualified resident of the country for purposes of the country's treaty with the United States. Since the Act treats U.S. persons as qualified owners of a foreign corporation, a foreign corporation which is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States is generally to be treated as a qualified resident of the country in which it is a resident.[6]

The Secretary may specify other circumstances in which a foreign corporation is not considered to be treaty shopping. For example, the Secretary may provide that a corporation is not treaty shopping where the foreign corporation operates an active trade or business in its residence country and that country does not provide special tax benefits with respect to the corporation's U.S. income that are not provided with respect to income derived within that country. As another example, the Secretary may find that a corporation is not treaty shopping despite the base erosion rule when more than half of a foreign corporation's income is used to satisfy liabilities outside the corporation's country of residence where the liabilities are bona-fide debt obligations to unrelated parties and are not back-to-back loans from nonresidents of the treaty country.

It was intended that in determining whether a foreign corporation is a qualified resident of a treaty country, the taxpayer has the burden of proof.

The interaction of U.S. income tax treaties with the Act's branch profits tax can be illustrated in the following examples. Assume a treaty with the United States prohibits the branch profits tax but it permits the withholding tax on dividends if the foreign corporation derives, for example, 50 percent or more of its income from the United States, and the corporation does in fact derive 50 percent or more of its income from the United States. In this case, the Act provides that the corporation is exempt from the branch profits tax but the withholding tax is imposed pursuant to the treaty's conditions whether or not the foreign corporation is treaty shopping.

Assume next that the foreign corporation derives less than 50 percent of its income from the United States. In this case, the branch profits tax is imposed if the foreign corporation with the U.S. branch is treaty shopping, since the treaty in question does not permit the withholding tax with respect to the foreign corporation. If the foreign corporation is not treaty shopping, no U.S. tax (branch profits or withholding) is imposed.

Assume a third case where a treaty with the United States prohibits both the branch profits tax and the dividend withholding tax. In this case, the branch profits tax is imposed if the foreign corporation with the U.S. branch is treaty shopping, but no tax (branch profits or withholding) is imposed if the corporation is not treaty shopping.

Further, Congress did not intend that the branch profits tax be imposed on income not attributable to a permanent establishment (even though the income is effectively connected with a U.S. trade or business under Code rules) if the business profits article of a treaty in question precludes the United States from imposing its regular corporate income tax on income not attributable to a permanent establishment, as long as the foreign corporation is not treaty shopping.

With respect to the branch-level tax on interest, the Act provides that U.S. treaty obligations are overridden if either the payor of interest or the recipient of interest is treaty shopping. For example, assume that a foreign corporation ("the taxpayer") with a U.S. branch claims a U.S. interest deduction of $100 in a taxable year. Eighty dollars of the amount deducted is paid by the branch to an unrelated second foreign corporation and $20 is allocated under Treas. Reg. sec. 1.882-5. The country in which the taxpayer is organized has a treaty with the United States that precludes the United States from imposing a tax on interest paid by residents of that country. The unrelated foreign corporation is organized in a second foreign country that precludes the United States from imposing its tax on interest paid to a resident of the second foreign country. Under the Act, these facts yield the following results.

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[6] A technical correction may be necessary so that the statute reflects this intent.

First, no U.S. withholding tax is imposed on the $80 of interest paid by the U.S. branch if the taxpayer is not treaty shopping. This is because the Act does not override the treaty between the United States and the taxpayer's home country. Even if the taxpayer is treaty shopping, U.S. withholding tax is precluded by the treaty between the United States and the second foreign country if the second foreign corporation is not treaty shopping. If both foreign corporations are treaty shopping, U.S. withholding tax at a 30-percent rate is imposed.

Second, with respect to the $20 of excess interest, U.S. tax at a 30-percent rate is imposed if the taxpayer is treaty shopping. In this instance, the Act looks to the treaty between the United States and the taxpayer's country. No U.S. tax is imposed if the taxpayer is not treaty shopping.

Regulations

The Act authorizes the Treasury Department to prescribe regulations necessary to carry out the purposes of the Act's provisions. Congress expected the Treasury Department to prescribe regulations that, among other things, address the potential abuse that may arise in the event a branch temporarily increases its assets at the end of its taxable year merely to reduce its branch profits tax base. The regulations are also intended to address the extent to which a decrease in assets may not indicate that the branch has remitted profits during the year.

Another case in which the Treasury Department may not consider it appropriate to impose a branch profits tax is the incorporation of a branch's entire operations where the earnings of the branch are contributed to the new corporation rather than remitted. The Internal Revenue Service has provided, in Notice 86-17, I.R.B. 1986-52, that branch tax may be deferred when a branch's U.S. net equity is eliminated on account of a transaction described in section 351. The notice indicates that regulations will address how subsequent events, such as distributions from the U.S. corporation or a sale of its stock, will trigger tax (branch profits or U.S. withholding) attributable to the branch tax deferred upon incorporation. It is noted that in a transaction solely described in section 351 the transferee corporation generally begins its existence with no earnings and profits. However, on the incorporation of a branch, Congress intended that branch tax could be only deferred, not eliminated, and it is anticipated that the IRS in future regulations will so provide.

Congress also believed that the imposition of the branch profits tax might be deferred when a branch's U.S. net equity is decreased on account of its acquisition of stock of a U.S. corporation, if branch tax would have been deferred had assets, rather than stock, been acquired. Such deferral is permissible as long as the income derived from the stock investment will generate effectively connected income that is attributable to a U.S. permanent establishment and, thus, is taxable by the United States on a net income basis. For example, the regulations may provide that where control of a U.S. corporation is acquired with a branch's profits it may be appropriate to defer imposition of the branch tax.

Regulations are to also address the application of the branch-level interest tax in cases where the payment of interest comes after the deduction, and vice-versa. For example, if an accrual basis taxpayer accrues its deduction in one year but pays the amount accrued the following year, regulations are to ensure that tax is only collected once.

Other rules

The Act reduces to 25 percent prior law's business income threshold for imposition of the withholding tax on dividends. The Act also provides that the withholding tax on dividends is not applicable where the branch profits tax generally may be imposed, even though no branch tax may be due in a particular taxable year. For example, if a branch, ordinarily liable for branch tax, reinvests its after-tax earnings in its trade or business during a particular taxable year so that no branch tax is due that year, the dividend withholding tax is not imposed even though the branch's business income exceeds 25 percent of the foreign corporation's total income and the corporation distributes dividends during the year. This is because the branch tax generally may be imposed, though none is due in the current year.

The Act makes it clear that the withholding tax on dividends, like the branch tax, applies to income from the disposition of real property, so that the United States will collect two levels of tax on this income. Income that is excluded from the branch tax (*e.g.*, certain FSC income), is also excluded from earnings and profits for purposes of imposing the withholding tax on dividends. No inference was intended by the modification of this provision about the interpretation of prior law.

Finally, Congress was concerned that the branch-level interest provision may lead to increased use of back-to-back loans by nontreaty residents and improper characterization of interbranch transactions by both treaty and nontreaty residents to avoid U.S. tax. Congress emphasized that back-to-back loans, as generally provided under prior law (see, for example, Revenue Ruling 76-192, 1976-1 C.B. 205), will be collapsed by the IRS, and the ultimate recipient will be subject to U.S. tax. Similarly, Congress expected the Internal Revenue Service to closely scrutinize the characterization of interbranch transactions. Congress recognized the difficulty that the Internal Revenue Service has in identifying these arrangements that erode the U.S. tax base and believed the tax-writing committees of the Congress should monitor collections and compliance with the interest provision adopted under the Act to ensure its continued viability, and, if necessary, propose legislation to obviate any abuses. Congress did not extend the treaty shopping prohibition to dividend and interest payments made by U.S. corporations because the appropriate extension of the theory embodied in Revenue Rulings 84-152, 1984-2 C.B. 381, and 84-153, 1984-2 C.B. 383, may provide appropriate federal income tax treatment for these and similar transactions.

Effective Date

The provisions are effective for taxable years beginning after December 31, 1986.

For U.S. branches of foreign corporations that have undistributed accumulated earnings and profits as of their first taxable years beginning on or after January 1, 1987, the Act's provisions apply only to earnings and profits generated in taxable years beginning after December 31, 1986, that are considered distributed from the branch to the home office (limited by post-effective date earnings and profits). Prior law's withholding tax on dividends applies to the pre-effective date accumulated earnings and profits that are distributed after the effective date. Thus, if a branch's income did not constitute at least 50 percent of the corporation's income for the base period prescribed under prior law, there is no withholding tax imposed on dividends paid after 1986 that represent pre-effective date earnings. Similarly, pre-effective date deficits in earnings and profits are not eligible to reduce post-effective date earnings in applying the branch profits tax. Post-effective date deficits in earnings and profits do not reduce pre-effective date earnings in applying prior law's withholding tax to distributions after 1986 where the distributions are attributable to pre-effective date earnings.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $13 million in 1987, $20 million in 1988, $23 million in 1989, $26 million in 1990, and $28 million in 1991.

2. Treatment of deferred payments and appreciation arising out of business conducted within the United States (retain character of effectively connected income) (sec. 1242 of the Act and sec. 864(c) of the Code)[7]

Prior Law

The United States taxes the worldwide income of U.S. citizens, residents, and corporations on a net basis at graduated rates. Nonresident aliens and foreign corporations are generally taxed only on their U.S. source income. The United States taxes foreign taxpayers' income that is "effectively connected" with a U.S. trade or business on a net basis at graduated rates, in much the same way that it taxes the income of U.S. persons. U.S. income of a foreign taxpayer that is not effectively connected with a U.S. trade or business is generally subject to a 30-percent withholding tax on the gross amount of the income, although certain types of this income earned by foreign investors, such as portfolio interest income, are exempt from U.S. tax. U.S. income tax treaties reduce or eliminate the 30-percent withholding tax in many cases. The United States does not generally tax foreign taxpayers on capital gains that are not connected with a U.S. trade or business (real property gains have been the major exception to this rule).

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[7] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 652; H.Rep. 99-426, pp. 435-436; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 953; S.Rep. 99-313, pp. 407-409; Senate floor amendment, 132 Cong. Rec. S 8227 and 8370 (June 24 and June 25, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 651 (Conference Report).

Although gains from the sale of assets used by a foreign corporation in a U.S. trade or business ordinarily would constitute effectively connected income fully subject to U.S. tax, under prior law foreign persons may have been able to avoid U.S. tax on income attributable to a U.S. trade or business if they received the income in a year after the trade or business had ceased to exist (*e.g.*, by selling property and recognizing the gain on the installment basis). Foreign persons may also have been able to avoid U.S. tax by removing property of a trade or business from the United States before its disposition.

Reasons for Change

Under prior law, foreign taxpayers could avoid U.S. tax by receiving income that was earned by a U.S. trade or business in a year after the trade or business had ceased to exist. For example, the business could sell property and accept an installment obligation as payment. By recognizing the gain on the installment basis, the taxpayer could defer the income to a later taxable year. If the taxpayer had no U.S. trade or business in that year, then the income recognized in that year was not treated as effectively connected with a U.S. trade or business. Congress believed that income earned by a foreign person's U.S. trade or business should be taxed as such, regardless of whether recognition of that income is deferred until a later taxable year. Similarly, Congress believed that foreign persons should not be able to avoid U.S. tax on their income from the performance of services in the United States where payment of the income is deferred until a subsequent year in which the individual is not present in the United States. Finally, Congress believed that gains accrued by a foreign person's U.S. trade or business should be subject to U.S. tax, and that such tax should not be avoidable through the simple expedient of removing property from the country prior to its disposition. Congress recognized that U.S. persons that transfer assets out of U.S. tax jurisdiction may be subject to tax on unrealized appreciation (sec. 367). Congress believed a similar rule is appropriate for foreign persons as well.

Explanation of Provisions

The Act amends section 864(c) to provide that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year. Thus, deferring the recognition of income until a later taxable year will no longer change the manner in which the U.S. tax system treats the income.

In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business.

A foreign corporation that is treated as deriving effectively connected income under these rules is also to be treated as engaged in trade or business in the United States during the taxable year in which the income arises. Moreover, any income treated as effectively connected by these provisions is to be considered attributable to a U.S. office of the U.S. trade or business.

For example, assume a foreign individual owns all the stock of a foreign corporation, which uses the calendar year as its fiscal year. The foreign corporation owns business property physically located in the United States. The foreign corporation ceases U.S. business activity in the United States at the end of 1987. If the foreign corporation had sold its property at a gain in 1987, the gain would have been attributable to its U.S. office and, thereby, U.S. source and effectively connected with a U.S. trade or business. Disregarding any effect of the rule provided by this provision of the Act, if the foreign corporation, however, had sold the property in 1989, the gain would not have been so connected, due to the cessation of U.S. business activities by it prior to the beginning of 1988. Under this provision of the Act, if the foreign corporation sells the property in 1989, any gain will be characterized as effectively connected. Similarly, if the foreign corporation, having ceased U.S. business at the end of 1987, completely liquidates in 1989 and either sells its property in liquidation or transfers its property to its shareholder, this provision characterizes any gain recognized as effectively connected with a U.S. trade or business.

Effective Date

These provisions apply to taxable years beginning after 1986. The provision treating deferred payments as generating effectively connected income (new sec. 864(c)(6)) applies only to income that arises from sales, exchanges, the performance of services, or other transactions occurring in taxable years beginning after 1986. Similarly, the provision determining effectively connected status as of the time of cessation of business (new sec. 864(c)(7)) applies only to property ceasing to be used in connection with a U.S. trade or business in a taxable year beginning after 1986. Thus, for example, the provision does not apply to a sale or exchange of property after 1986 if the cessation of business occurred prior to 1987.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

3. Treatment under section 877 of property received in tax-free exchanges, etc. (sec. 1243 of the Act and sec. 877 of the Code)[8]

Prior Law

A U.S. citizen who gives up citizenship for a principal purpose of avoiding U.S. tax will, for ten years, continue to be taxed as a citizen on U.S. source income, but not foreign source income, under Code section 877. U.S. income of such tax-avoidance expatriates will thus be subject to tax on a net basis at graduated rates, regardless of how such income would be taxed to a nonresident alien. U.S. income for this purpose includes gains from sales of U.S. property (i.e., property located in the United States, stock of U.S. corporations, and debt obligations issued by any U.S. person, including Federal, state and local governments).

Reasons for Change

Tax-avoidance expatriates may under prior law have been able to avoid U.S. tax by making a tax-free exchange of U.S. property for foreign property. The sale of the U.S. property would have been subject to U.S. tax, but the sale of the foreign property would not have been. Congress believed that expatriates should not be permitted to accomplish indirectly that which they are prohibited from doing directly.

Explanation of Provision

The Act amends section 877 to provide that gain on the sale or exchange of property whose basis is determined in whole or in part by reference to the basis of U.S. property is treated as gain from the sale of U.S. property. Thus, expatriates will still be permitted to make tax-free exchanges of U.S. property for foreign property. However, a subsequent disposition of that foreign property (on which gain is recognized) will be treated as a disposition of U.S. property, and will therefore be subject to U.S. tax.

Effective Date

The provision applies to dispositions of property acquired in tax-free exchanges after September 25, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

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[8] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 653; H.Rep. 99-426, p. 438; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 954; S.Rep. 99-313, pp. 409-410; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 651-652 (Conference Report).

4. Study of competitive effect on U.S. reinsurers of U.S. tax treaty exemptions for foreign insurers and reinsurers (sec. 1244 of the Act)[9]

Prior Law

U.S. reinsurers, like other U.S. persons, are generally taxed on a net basis on their worldwide income.

Foreign reinsurers generally are subject to U.S. income tax on income derived from the reinsurance of risks located in the United States in situations where that reinsurance income is effectively connected with a U.S. trade or business. However, foreign reinsurers reinsuring U.S. risks ordinarily will not be viewed as conducting a U.S. trade or business and thus will not be subject to U.S. income tax if they have no U.S. office or agent. U.S. income tax treaties may further limit the circumstances in which foreign reinsurers are subject to U.S. income tax.

When a foreign reinsurer is not subject to U.S. income tax, an excise tax generally is imposed on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by the foreign reinsurer to, or for, or in the name of a domestic corporation or partnership, or a U.S. resident individual with respect to risks wholly or partly within the United States, or to, or for, or in the name of any foreign person engaged in business within the United States with respect to risks within the United States (Code sec. 4371). The excise tax is imposed at the rate of (1) 4 cents on each dollar (or fraction thereof) of the premium paid on a policy of casualty insurance or indemnity bond; (2) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of life, sickness, or accident insurance, or annuity contract on the life or hazards to the person of a U.S. citizen or resident, unless the insurer is subject to U.S. tax subject to the adjustments under Code section 813 (relating to the taxation of foreign life insurance companies); and (3) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of reinsurance covering any of the contracts taxable under (1) or (2).

Present law and prior law provide exemptions from the excise tax in the case of (1) policies signed or countersigned by an officer or agent of the insurer in a State or the District of Columbia, within which such insurer is authorized to do business, or (2) any indemnity bond required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-saving certificate, warrant, or check issued by the United States (Code sec. 4373).

The excise tax also may be waived in certain cases under certain recent U.S. tax treaties, such as it is in the United States-Barbados Income Tax Treaty, the United States-Cyprus Income Tax Treaty, the United States-United Kingdom Income Tax Treaty and the United States-France Income Tax Treaty. Although premiums received by certain persons may be exempt from the excise tax

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[9] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 955; S.Rep. 99-313, pp. 410-412; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 652 (Conference Report).

(whether by treaty or by statutory exception), such exceptions generally do not waive the excise tax for subsequent reinsurance transactions covering insurance of U.S. risks under which premiums are paid to and received by a nonexempt person.

Reasons for Change

Congress was concerned that U.S. reinsurers may be at a competitive disadvantage vis a vis foreign reinsurers of U.S. risks as a result of the disparate U.S. tax treatment of U.S. and foreign reinsurers. While U.S. reinsurers are subject to U.S. tax on their worldwide income, foreign reinsurers are frequently not taxed by the United States on income attributable to the reinsurance of U.S. risks. The excise tax on insurance premiums paid to foreign reinsurers operates to mitigate this inequality of treatment in some cases. However, many foreign reinsurers of U.S. risks are exempt from this excise tax under U.S. treaties. If U.S. reinsurers are at a significant competitive disadvantage vis a vis foreign reinsurers of U.S. risks as a result of these treaty exemptions, Congress may consider legislation directing the Secretary of the Treasury to renegotiate the treaties in question to eliminate that disadvantage.

Explanation of Provision

The Act requires the Secretary of the Treasury to conduct a study to determine whether U.S. reinsurance corporations are placed at a significant competitive disadvantage vis a vis foreign reinsurance corporations by reason of existing treaties between the United States and foreign countries, specifically identifying any treaties that create a significant competitive disadvantage. The Secretary is to report the results of this study to the Senate Committees on Finance and Foreign Relations and the House Committees on Ways and Means and Foreign Affairs before January 1, 1988. If the study indicates that U.S. reinsurance corporations are at such a competitive disadvantage, Congress believed that the Secretary of the Treasury should renegotiate the relevant treaties to eliminate that disadvantage.

Effective Date

This provision was effective on the date of enactment, October 22, 1986.

Revenue Effect

This provision is estimated to have a negligible effect on budget receipts.

5. Reporting by foreign-controlled corporations (sec. 1245 of the Act and secs. 6038 and 6038A of the Code)[10]

Prior Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added new reporting requirements under Code section 6038A for certain foreign-controlled corporations. In general, these requirements apply both to U.S. corporations and to foreign corporations engaged in trade or business in the United States ("reporting corporations"), but only if they are controlled by a foreign person (defined to include certain possessions residents). This control test requires reporting if at any time during a taxable year a foreign person owns 50 percent or more of the stock of the reporting corporation (either by value or by voting power).

The reporting corporation must furnish certain information about any corporation that (1) is a member of the same "controlled group" as the reporting corporation (a group that generally includes brother-sister corporations as well as the reporting corporation's parent and subsidiaries)[11] and that (2) has any transaction with the reporting corporation during the taxable year. The information that the reporting company is to report is such information as the Secretary may require that relates to the related company's name, its principal place of business, the nature of its business, the country in which it is organized and in which it is resident, its relationship with the reporting corporation, and its transactions with the reporting corporation during the year.

U.S. persons are also required to furnish certain information with respect to any foreign corporations they control.

Reasons for Change

Congress believed that the reporting requirements of section 6038A should be extended to apply to transactions with related persons other than corporations. Transactions between related persons could often be manipulated by foreign taxpayers to avoid U.S. tax. For example, the foreign owners of a U.S. corporation may attempt to reduce the U.S. corporation's taxable income by selling it property at unrealistically high prices. Such owners may be individuals, corporations, or other legal entities. Congress added the reporting requirements of section 6038A to help the IRS obtain sufficient information to detect and challenge such abusive transactions. However, these requirements under prior law were too narrow. A corporation subject to section 6038A was required to report only with respect to its transactions with other corporations in the same controlled group; no reporting was required with respect to other related foreign persons that are not corporations, such as partnerships, trusts, and individuals. Congress believed that transactions with noncorporate related persons, like transactions with related corporations, may be subject to transfer pricing and other abuses, and, therefore, that similar reporting requirements should apply to transactions with noncorporate related persons. The absence of parallel reporting rules may have encouraged taxpayers to include noncorporate related persons in their chain of ownership, so as to defeat the intended operation of section 6038A.

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[10] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 986(c) ; S.Rep. 99-313, pp. 412-414; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 653 (Conference Report).

[11] For the purpose of the reporting requirement, the term "controlled group" incorporates the definition of controlled group of corporations in section 1563(a) with certain changes in the percentage tests of that section and with certain exceptions. Although under section 1563(b) foreign corporations subject to tax under section 881 and certain other corporations are "excluded members" of a controlled group rather than "component members" for the purpose of section 1561, the exclusion of these corporations from the definition of "component members" for that purpose does not remove them from the controlled group, as defined in section 1563(a). Therefore, TEFRA requires reporting about any foreign corporation that otherwise qualifies as a member of the controlled group.

In this context, Congress believed that, to determine whether a party is related to a corporation, objective standards should supplement the section 482 standard.

Congress believed that reporting requirements were necessary to carry out the purposes of new Code section 453C, which treats certain indebtedness as payment on installment obligations.

Explanation of Provision

Under the bill, a corporation subject to the reporting requirements of section 6038A must report with respect to its transactions with all related persons (within the meaning of sections 267(b), 707(b)(1), or 482), not merely its transactions with corporations in its controlled group. In addition, the Act adds a requirement that U.S.-controlled foreign corporations, foreign-controlled U.S. corporations, and foreign-controlled foreign corporations doing business in the United States report such information as the Secretary may require for purposes of carrying out the installment sales rules described in new section 453C. Congress noted that the limitations imposed by section 6103, relating to confidentiality of information, are to apply to the disclosure of any information provided to the Internal Revenue Service pursuant to this latter provision.

Effective Date

The amendment applies to taxable years beginning after December 31, 1986.

Revenue Effect

The amendment is estimated to increase fiscal year budget receipts by less than $5 million annually.

6. Withholding tax on amounts paid by partnerships to foreign partners (sec. 1246 of the Act and sec. 6401 and new sec. 1446 of the Code)[12]

Prior Law

Under present and prior law, foreign persons receiving U.S. source income are in a number of cases subject to withholding of U.S. tax by the payor of that income. As a general rule, withholding is required with respect to passive income received by foreign investors who have limited contacts with the United States and from whom it would otherwise be difficult to collect tax. On the other hand, withholding generally is not required with respect to income that foreign persons earn through the active conduct of a trade or business in the United States, since such persons generally have a substantial presence in the United States.

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[12] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 985; S.Rep. 99-313, pp. 413-415; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 653-654 (Conference Report).

If a foreign person invested in the United States through a partnership, the withholding rules that applied to distributions by the partnership were determined under prior law by reference to the types of income earned by the partnership. If the income earned by the partnership would not have been subject to withholding if the income had been earned directly by a foreign person (i.e., income earned through the active conduct of a trade or business), then no withholding was imposed when that income was earned by a partnership and distributed to its partners.

Reasons for Change

Congress was concerned that the prior structure of withholding rules applicable to foreign persons who invested in the United States through partnerships may have permitted passive investors to escape U.S. taxation on their income. Foreign persons who acquired U.S. partnership interests have frequently done so as portfolio investments, representing the functional equivalent of stock investments. In fact, interests in a number of U.S. partnerships have been publicly traded on stock markets in a manner indistinguishable from corporate stock. These types of partnership investments ordinarily do not represent the type of substantial and continuing U.S. presence that justifies the absence of a withholding requirement. Moreover, Congress did not believe that a partnership's conduct of a U.S. trade or business provided adequate assurance that its foreign partners would comply with U.S. tax laws even where the partnership is not publicly traded. In these cases, the investors were required to file U.S. tax returns and pay U.S. tax, but if they failed to do so the IRS was likely to find it nearly impossible to locate them and collect the tax. Therefore, Congress believed that all effectively connected income earned by foreign persons through U.S. partnerships should be subjected to U.S. withholding tax to ensure collection of such persons' U.S. income tax liability.

Explanation of Provision

The Act provides that the following withholding rules will apply to distributions to foreign partners in U.S. or foreign partnerships that have any income effectively connected with the conduct of a U.S. trade or business. First, present law rules requiring withholding at 30 percent (or reduced treaty rates) with respect to distributions attributable to dividends, certain interest, and other fixed or determinable annual or periodic income not effectively connected with the conduct of a U.S. trade or business will continue to apply to such distributions (or if this income is exempt by treaty, withholding will continue not to be required). It is intended that any distribution by the partnership be considered to come first out of these types of income received by partnerships.

Second, any partnership distribution in excess of the amounts described immediately above is subject to withholding at a 20-percent rate. The amount withheld is creditable against the U.S. income tax liability of the foreign partner. Amounts withheld in excess of a foreign person's tax liability are treated by the Act as an overpayment of tax. Where interests in a publicly traded partnership are held through one or more nominees, it is intended that withholding be carried out under the principles of section 1441(a): withholding is required by the last U.S. person in the chain of ownership.

Third, if a partnership's gross income effectively connected with a U.S. trade or business over a three-year period (or shorter period if the partnership is not in existence for three years) is less than 80 percent of the total gross income of the partnership over that period, then withholding is required only on the proportion of current distributions that the partnership's gross income effectively connected with its U.S. trade or business bears to the partnership's total gross income over its previous three taxable years (or shorter period if the partnership is not in existence for three years).

Fourth, the Act provides that, unless otherwise provided in regulations, withholding is not required if substantially all of the U.S. source income and substantially all of the income effectively connected with a partnership's U.S. trade or business is allocable to U.S. partners pursuant to a valid special allocation under section 704(b) and regulations thereunder. This provision exempting withholding is not intended to apply, for example, to a partnership which has only U.S. source income and in which foreign persons hold only a minority interest such that, on a straight allocation, "substantially all" of the partnership's income could be considered to be allocated to U.S. persons. Instead, it is intended only to apply to a partnership which specially allocates its U.S. source income to U.S. persons and its foreign source income to foreign persons.

Further, the Act provides specific regulatory authority to coordinate the new withholding rule with the FIRPTA withholding requirements to prevent duplicative withholding on the same amount of income and contains general regulatory authority for the Secretary to carry out the Act's provisions. For example, the regulations are to specify the proper withholding agent in the case of tiers of partnerships, and the appropriate withholding requirement in the case of a partnership that has effectively connected income for the first time. In addition, the Act's withholding requirement may increase the likelihood that foreign persons who can claim tax exemption for interest payments will try to structure their U.S. investments as loans rather than capital contributions. It is expected that regulations address this concern to look through the substance of the transaction if necessary to prevent tax avoidance. Moreover, the Secretary may prescribe regulations that waive withholding in circumstances where collection of U.S. tax is assured.

Effective Date

The provision applies to distributions after the date prescribed in regulations, or if earlier, December 31, 1987, but not before January 1, 1987.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

7. Income of foreign governments and international organizations (sec. 1247 of the Act and sec. 892 of the Code)[13]

Prior Law

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or international organizations, or from interest on deposits in banks in the United States of money belonging to such foreign governments or international organizations, or from any other source within the United States, was not included in gross income and was exempt from U.S. income taxation (Code sec. 892). Regulations made clear that this exemption did not apply to any income from commercial activities in the United States (Reg. sec. 1.892-1(a)(3)). That is, the exemption extended only to investment income.

Under regulations, the exemption for investment income extended to integral parts of a foreign government such as agencies and bureaus, so long as the earnings of these parts of a government were credited to their own accounts or to other accounts of the foreign government, with no portion inuring to the benefit of any private person (Reg. sec. 1.892-1(b)). In addition, regulations generally extended the exemption for investment income to entities (such as corporations) which were separate in form from a foreign government if they were wholly owned and controlled by the foreign government directly or indirectly and if all their earnings currently or eventually benefited the foreign government and no private persons (*id.*). Regulations also provided that the exemption extended to certain pension trusts benefiting government employees or foreign employees and to political subdivisions of foreign countries (*id.*).

Regulations specified that taxable commercial activities, for this purpose, did not include investments in the United States in stocks (whether or not a controlling interest investment), bonds, or other securities, loans, net leases on real property, or the holding of deposits in banks (Reg. sec. 1.892-1(c)). The regulations specified, in addition, that an activity did not cease to be a nontaxable investment solely because of the volume of transactions of that activity or because of other unrelated activities (*id.*). Performances and exhibitions within the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations were not commercial activities (*id.*).

Similar statutory rules apply to income of international organizations.

A separate exemption applies to certain income of foreign central banks of issue (sec. 895). A further exemption applies to certain income of employees of foreign governments (sec. 893).

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[13] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 982; S.Rep. 99-313, pp. 415-418; Senate floor amendment, 132 Cong. Rec. S8054 (June 20, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 654-655 (Conference Report).

Some U.S. income tax treaties specifically cover some income earned by governments. In other cases, the provisions of an income tax treaty with a foreign government do not appear to grant U.S. tax relief to that foreign government when it is subject to U.S. tax. Some recent treaties generally allow protection only to "residents" of the treaty partner country. A typical definition of "resident" of a country for treaty purposes is "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature . . . ." (Treasury Department's Model Income Tax Treaty of June 18, 1981, Article 4). Under this definition, treaty protection for a foreign government might seem to turn, for instance, on whether it is liable for its own tax.

Some form of exemption for income of foreign governments has been in the U.S. tax law since 1917. A 1920 ruling distinguished between income earned by a foreign ruler "in his individual capacity", which was taxable, and income earned on property "belonging to the crown", which was not taxable. O.D. 483, 2 C.B. 96 (1920), declared obsolete, Rev. Rul. 70-293, 1970-1 C.B. 282. There has been some confusion about the extent of the exemption.[14]

Reasons for Change

Congress' examination of prior law's tax exemption for investment income of foreign governments revealed several problems. First, as interpreted by Regulations, the exemption extended to certain income earned by entities, even corporations engaged in commmercial activities, wholly owned by foreign governments. This treatment tended to favor, for example, nationalized industries over privately owned industries. Under prior law, the United States taxed U.S. source investment income received by a privately-owned foreign business corporation but not similar income received by a state-owned business corporation. Congress did not believe that this difference in treatment was appropriate.

Second, prior law provided an exemption for income (such as interest and dividends) derived by foreign governments or governmental entities from U.S. businesses that they controlled. For example, a foreign government might have bought a controlling interest in a U.S. corporation. Dividend and interest payments from that corporation to the foreign government escaped U.S. shareholder level tax. While an exemption for income from passive investments may be appropriate in some cases, payments to a controlling entity, in Congress's view, are in the nature of a return on a direct investment, not on a portfolio investment. These payments, in Congress's view, are not passive investment income. Congress did not believe that exemption is appropriate in this case.

Third, under a literal reading of prior statutory language, not only was income of foreign governments from stocks, bonds, etc., exempt from U.S. tax, income "from any other source within the United States" was exempt, too. While Regulations properly limited this exemption to other investment income, Congress intended to make it clear that the exemption applies only to specified income items.

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[14] *See* Tillinghast, *Sovereign Immunity from the Tax Collector; United States Income Taxation of Foreign Governments and International Organizations*, 10 Law and Policy in International Business 495, 503 (1978).

In connection with its decision to limit the tax exemption for foreign governments, Congress addressed the issue whether governments are entitled to tax treaty benefits, such as those that extend to persons liable for tax in a foreign country. Congress concluded that the U.S. tax exemption to a foreign government that is a treaty partner should not depend, for instance, on its internal sovereign immunity laws. Congress saw no reason to treat a foreign government worse than comparable private investors from the government's country. Therefore, Congress believed it appropriate to treat foreign countries as residents of themselves for purposes of applying treaty rules to income affected by this provision of the Act, so long as the country at issue does not deny similar treatment to the United States.

Explanation of Provision

The Act limits the tax exemption for foreign governments to three kinds of income: income from their investments in the United States in stocks, bonds, or other domestic securities; income from their investments in the United States in financial instruments they hold in the execution of their governmental financial or monetary policy; or income from interest on their deposits in banks in the United States. Income that does not fall within one of the above three categories is not eligible for this exemption. Income from commercial activities (wherever conducted), whether or not it falls within one of these three categories, is not eligible for this exemption. Similarly, income received from or by a controlled commercial entity is not eligible for this exemption. The Act generally defines controlled commercial entity to mean any entity engaged in commercial activities (whether within or outside the United States) if the government owns a controlling interest in the entity. For this purpose, controlling interest means a direct or indirect interest of 50 percent or more, by vote or value, in a U.S. corporation or other entity, or any other direct or indirect interest that provides the foreign government effective control. For this purpose, there is aggregation of commonly owned interests.

For example, a foreign government owns 50 percent of a U.S. corporation. Under the Act dividends paid by the U.S. corporation to the foreign government are subject to tax on a gross withholding basis. The rate of tax is 30 percent, unless reduced by treaty. Similarly, gross interest payments from the U.S. corporation to the foreign government (or a related party) are generally subject to a 30-percent withholding tax. (In some cases they are subject to tax at a lower treaty rate, but interest payments to a related party such as a 10-percent shareholder do not qualify for the tax exemption that section 871 of the Code provides for portfolio interest.) Thus, the Act ensures taxation of income derived directly or indirectly by foreign governments from commercial activities.

As another example, assume that a foreign government owns all the shares of a U.S. holding company that owns all the shares of a U.S. operating company. The U.S. holding company deducts all the dividends it receives from the operating company by virtue of the 100-percent dividends received deduction. Under the Act, dividends from the holding company to the foreign government are not exempt; Congress intended that they be treated as received from a controlled commercial entity.

Under the Act, if a controlled entity is itself engaged in commercial activity anywhere in the world, its income is treated like income of a privately owned entity. Income it receives is not exempt under this provision and payments it makes are not eligible for the exemption.

For example, an incidental loan into the United States by a bank, wholly owned by a foreign government, might not in and of itself constitute commercial activity in the United States. Assume that the interest does not qualify as portfolio interest, and that the U.S. tax on that interest is not eliminated by treaty. Interest on that loan is subject to tax under the bill, because the foreign entity, though not engaged in a U.S. trade or business, is engaged in business elsewhere.

However, if a controlled entity is not itself engaged in any commercial activity, in general, the Act provides tax exemption for certain investment income earned by that controlled entity, whether or not any entity related to that controlled entity is engaged in commercial activity, and the Act provides exemption for interest and dividend payments from the entity to the government. The Act treats a foreign central bank of issue as a controlled commercial entity, however, only if engaged in commercial activities within the United States.

The Act directs the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section. Congress anticipated that these regulations will address shifting of income from commercial arms of foreign governments to other related entities not engaged in commercial activity. For instance, Congress anticipated that regulations would treat an investment subsidiary of a government-owned commercial entity as engaged in commercial activity itself. Congress adopted this approach of a regulatory solution in lieu of a rule (contained in the Senate amendment) that would automatically attribute commercial activity of one controlled entity to all related entities.

Once a foreign governmental entity is found to engage in commercial activity somewhere in the world, the United States must determine whether to impose its tax on any particular U.S. source income of that entity on a net basis or a gross basis. For this purpose, Congress intended that the principles distinguishing income taxed on a net basis and income taxed on a gross basis for private foreign persons apply to foreign governments also. For example, assume that a foreign government owns an airline. The airline does not fly to or from the United States, and it is not otherwise engaged in the conduct of a trade or business in the United States. The airline purchases 2 percent of the stock of a U.S. airline corporation. Dividends paid with respect to that stock are taxable on a gross basis, at the 30-percent or lower treaty rate, because they are not effectively connected with the conduct of a U.S. trade or business. Some income earned by a foreign governmental entity may be taxed by the United States on a net basis: the standards that determine whether the income of a privately owned foreign corporation is effectively connected income (and thus subject to U.S. tax on a net basis) apply equally to foreign governments and to foreign corporations that they control.

Congress did not believe that income derived by foreign governments' athletic teams and cultural groups should be treated differently from similar income earned by privately-owned foreign professional teams or groups. That income is not in the nature of investment income. In such a case, if a treaty prevents U.S. taxation, or if the team or group qualifies for nonprofit status under Code section 501(c), there will be no tax.

Congress intended that, for treaty purposes, a foreign government be treated as a resident of its country, unless it denies treaty benefits to the United States. Congress intended that similar treatment apply to agencies and bureaus of foreign governments, and to corporations owned by foreign governments that are residents of its country under the treaty, so long as the country does not deny reciprocal treatment to comparable U.S. entities.

With respect to international organizations described in section 7701(a)(18), the Act makes no change to prior law.

Effective Date

This provision is effective for amounts received or accrued on or after July 1, 1986, although no withholding obligation is imposed for amounts paid prior to the date of enactment.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $23 million in 1987, $43 million in 1988, $48 million in 1989, $53 million in 1990, and $58 million in 1991.

8. Transfer prices for imports (sec. 1248 of the Act and sec. 1059A of the Code)[15]

Prior Law

When a U.S. taxable entity imports goods into the United States for resale or use in its business, there may be an incentive to state a high price for the goods, thus reducing U.S. taxable income, particularly when the goods are purchased from a related foreign party that is not subject to U.S. tax. On the other hand, if imported goods are subject to a tariff or other import duty, there is an incentive to state a low value for U.S. customs purposes.

The Secretary of the Treasury is authorized to allocate income between commonly controlled entities as necessary to prevent evasion of taxes or clearly to reflect income (sec. 482). Treasury regulations prescribe a reallocation of income where the price charged between such commonly controlled entities is not arm's-length. There are frequently questions of fact regarding what constitutes an arm's length price for goods.

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[15] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 981; S.Rep. 99-313, pp. 418-419; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 656 (Conference Report).

Reasons for Change

Congress understood that some importers could claim a transfer price for income tax purposes that was higher than would be consistent with the transfer price claimed for customs purposes. *See Robert M. Brittingham*, 66 T.C. 373 (1976), *aff'd,* 598 F.2d 1375 (5th Cir. 1979). Congress was particularly concerned that such practices between commonly controlled entities could improperly avoid U.S. tax or customs duties. Changes in U.S. customs laws after the 1979 Tokyo Round generally make transactions-based pricing the rule for customs purposes. In enacting the new provision, Congress did not express the view that valuation of property for customs purposes should always determine valuation of property for U.S. income tax purposes. Instead, Congress was concerned only with establishing a limit on the price an importer could claim for income tax purposes.

Explanation of Provision

The Act provides that importers subject to U.S. tax may not claim a transfer price for U.S. income tax purposes that is higher than would be consistent with the value they claim for customs purposes. This rule applies to transfer prices between commonly controlled entities, as defined in Code section 482. Congress expected that the Secretary will provide rules for coordinating customs and tax valuation principles, including provision for proper adjustments for amounts such as freight charges, items of American content returned, and sales commissions where customs pricing rules may differ from appropriate tax valuation rules.

Although customs value (as appropriately adjusted) provides a ceiling on transfer price valuation for income tax purposes, it does not provide a floor on that valuation. In addition, in no event does a customs declaration or customs valuation constrain the ability of the Commissioner to adjust transfer prices under section 482.

Congress intended that the transfer price ceiling imposed by the Act not be waived by the competent authority unless an appropriate adjustment is first made for U.S. customs purposes.

Effective Date

The provision applies to transactions entered into after March 18, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

9. Dual residence companies (sec. 1249 of the bill and sec. 1503 of the Code)[16]

Prior law

A corporation that is created or organized in the United States or under the laws of the United States or of any State is a "U.S. corporation." (U.S. corporations are sometimes referred to a U.S. resident corporations.) The United States taxes every U.S. corporation on its worldwide income (with allowance of a foreign tax credit) and allows it to deduct losses wherever incurred. The United States allows U.S. corporations to file consolidated tax returns with other U.S. corporations that are commonly owned. When two or more U.S. corporations file a consolidated return, losses that one corporation incurs generally may reduce or eliminate tax on income that another corporation earns.

Some countries use criteria other than place of incorporation to determine whether corporations are residents for their tax purposes. In particular, some countries, including the United Kingdom and Australia, treat corporations as domestic residents if they are managed or controlled there. If one of these foreign countries determines a corporation to be its resident, that foreign country typically taxes it on its worldwide income and allows it to deduct losses wherever incurred. In some cases, these two foreign countries allow losses of a resident corporation to reduce or eliminate tax on income of other commonly owned resident corporations.

For tax purposes, a corporation may be at the same time a U.S. resident for U.S. purposes and a resident of another country for its purposes if the other country uses a standard other than place of incorporation to determine residency. For example, a U.S. corporation can also be a resident of the United Kingdom or Australia under their respective rules. Such companies are sometimes referred to as "dual resident companies." A dual resident company is taxable in both countries on its worldwide income (or it could deduct its worldwide losses in both countries). In addition, if the foreign country has provisions that, like the U.S. consolidated return provisions, permit commonly controlled resident corporations to combine their income and losses, such a dual resident company may be able, in effect, to use any losses it generates twice at the same time—separately offsetting the income of its affiliates resident in the United States (but not abroad) and again offsetting the income of its affiliates resident only in the other country. (Congress was aware of the ability to share losses in this way in the case of Australia and the United Kingdom; this ability may occur in other cases as well.)

Corporate groups attempted to isolate expenses in dual resident companies so that, viewed in isolation, the dual resident company was operating at a loss for tax purposes. This isolation of expenses allowed, in effect, the consolidation of tax results of one money-losing dual resident corporation with two profitable companies, one in each of two countries. The profitable companies, however, reported their income to only one country.

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[16] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 983; S.Rep. 99-313, pp. 419-421; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 656-658 (Conference Report).

Reasons for Change

Losses (however derived) that a corporation uses to offset foreign tax on income that the United States does not subject to current tax should not also be used to reduce any other corporation's U.S. tax. Disallowing such losses allows foreign and U.S. investors to compete in the U.S. economy under tax rules that put them in the same competitive position. By allowing "double dipping" (use of a deduction by two different groups), the prior treatment of dual resident companies gave an undue tax advantage to certain foreign investors that made U.S. investments.

For example, under prior law, a profitable U.K. company would acquire a profitable U.S. target by establishing a dual resident holding company to own the shares of the U.S. target. The dual resident company borrowed funds with which to buy the target. The interest expense of the dual resident company appeared on both the U.K. and the U.S. returns. It was conceivable that an affiliated group could have worldwide profits from operating in just two countries, the United Kingdom and the United States, yet, by using the dual resident company device, pay no current taxes to either country.

As an example, assume that a U.K. corporation earned $100 of income before purchasing a U.S. target. The target produced $100 of income. To finance the purchase of the target, the U.K. corporation established a dual resident company that incurred interest expense of $100. The dual resident company effectively shared its loss with its U.K. parent, so the group's U.K. taxable income shrank from $100 to 0. In the United States, the dual resident company consolidated with its subsidiary, the U.S. target, so U.S. taxable income was zero. Despite worldwide profits of $100, earned solely in the United States and the United Kingdom, the group owed no current tax to any country.[17]

In the example above, the U.K. corporation reduced its U.K. tax on U.K. income (and its worldwide tax on worldwide income) by making the investment in the United States through the dual resident company device. That is, the marginal tax rate on that investment was negative. That result occurred even though the target's income exactly offset the expenses of financing the acquisition. By contrast, if a similar U.S. corporation bought the same U.S. target corporation through the use of the same amount of debt, it would not reduce its tax. For example, assume that a U.S. corporation earned $100 of income before purchasing a U.S. target. The target produced $100 of income. To finance the purchase of the target, the U.S. corporation established a holding company that incurred interest expense of $100. The holding company effectively shared its loss with the other members of the U.S. group, but the group's taxable income remained at $100. There was no reduction of the group's total tax liability, as there was when a U.K. corporation bought a U.S. corporation through the use of the dual resident corporation device. Congress believed that the dual resident company device created an undue incentive for U.K. corporations (and Australian corporations) to acquire U.S. corporations and otherwise to gain an advantage in competing in the U.S. economy against U.S. corporations. Similarly, the dual resident company device created an undue incentive for U.S. corporations to acquire foreign rather than domestic assets.

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[17] See "Dollars at 0.2% After Tax? How a UK Company Did It Via a Dual-Residence Sub," *Business International Money Report*, December 20, 1985, at 401.

Some taxpayers argued that the United States should not consider the tax treatment that foreign countries apply to U.S. corporations. In particular, they argued that U.S. tax results should not turn on whether foreign countries allow U.S. corporations to share losses with affiliates. The United States frequently takes foreign taxation into account, however. In particular, in allowing a foreign tax credit, the United States carefully considers the tax systems of foreign countries. (In allowing a deemed-paid foreign tax credit, the United States even allows foreign tax treatment of foreign corporations to operate to reduce the U.S. tax obligations of U.S. corporations.)

Explanation of Provision

The Act provides that if a U.S. corporation is subject to a foreign country's tax on worldwide income, or on a residence basis as opposed to a source basis, any net operating loss it incurs cannot reduce the taxable income of any other member of a U.S. affiliated group for that or any other taxable year. (A net operating loss of such a company is referred to as a "dual consolidated loss.") A company may be subject to foreign tax on a residence basis because its place of effective management is in a foreign country or for other reasons. Where a U.S. corporation is subject to foreign tax on a residence basis, then, under the Act, for U.S. purposes, its loss will be available to offset income of that corporation in other years, but not income of another U.S. corporation. Regulatory authority is provided to exempt a U.S. corporation from this rule to the extent that its losses do not offset the income of foreign corporations for foreign tax purposes.

The Act does not, however, exempt a U.S. corporation that resides in a foreign country from the rule merely because its losses do not in fact reduce foreign tax of any foreign corporation. Congress was concerned that a foreign country, in response to this U.S. legislation, might deny loss-sharing to its corporate residents that are incorporated in the United States. In fact, in response to this U.S. legislation, the United Kingdom has indicated that it will seek to prevent the use of interest-deduction-related losses generated by U.S. corporations that are U.K. residents against the taxable income of other U.K. residents. Congress, foreseeing adoption of such a rule by (for example) the United Kingdom, did not intend that such a rule of foreign law cause all the revenue gain from termination of the dual resident company device to inure to the benefit of the foreign revenue authority. (If the U.S. rule had applied only to companies whose losses actually reduced the income of a foreign corporation, then after application of, for example, a U.K. rule that denies loss-sharing to U.S. corporations that are U.K.

residents, the Act's new rule would have had no possible impact on a U.S. corporation resident in the United Kingdom.)

Instead, Congress intended that the U.S. Treasury Department pursue with the appropriate authorities of any foreign country adopting the approach that the United Kingdom has adopted a bilateral agreement allowing losses of a dual resident company to offset income of affiliates in only one country. When such an agreement is effective, or when the circumstances otherwise insure that the United States obtains an appropriate share of revenue from Congress' action in ending use of this dual resident company device, then Congress intended that regulations exempt from "dual consolidated loss" treatment losses that do not offset the income of any foreign corporation. Until that time, however, the Act's limitation on use of dual consolidated losses is generally to apply to losses of any U.S. corporation that is subject to a foreign country's tax on worldwide income, or on a residence basis as opposed to a source basis, regardless of whether those losses offset income of a foreign corporation for foreign purposes.

Even absent action to protect U.S. revenues, however, Congress anticipated that regulations will provide that a U.S. corporation that is taxed on a residence basis by a foreign country, that has no affiliates in that country whose foreign tax its losses could reduce, and whose losses do not otherwise reduce foreign tax of a foreign corporation, will not be subject to this provision.

Congress adopted a rule preventing use of losses, in lieu of a prohibition of consolidation, because of its view that the collateral implications of deconsolidation were sometimes undesirable. For example, if a U.S. corporation that is a dual resident corporation wholly owns several U.S. subsidiaries, denial of consolidation to the dual resident corporation would automatically have prevented application of the consolidated return rules to transactions between two of its U.S. subsidiaries under current regulations. Congress saw no reason to prohibit application of the consolidated return rules in that case, so long as the dual resident corporation's losses do not reduce the U.S. taxable income of some other U.S. corporation. Thus, for example, losses of U.S. members of a consolidated group that includes one dual resident affiliate may be used to offset the income of that dual resident affiliate for U.S. tax purposes but not vice versa. This would be true even if the dual resident company was included in a foreign consolidated return and losses of foreign affiliates were used to offset its income for foreign tax purposes. No improper sharing of losses occurs in this case because no loss is used in both jurisdictions.

Congress did not perceive any relevant distinction between a deduction that arises on account of interest expense and one that arises on account of some other expense, or between a deduction for a payment to a related party and one for a payment to an unrelated party. Therefore, the provision applies to any dual consolidated loss regardless of the type of deductions that caused it.

The Act's provision applies to losses of dual resident companies whether or not any of the income of any foreign corporation that the dual resident corporation's loss may reduce in the foreign country is or will be subject to U.S. tax. Congress applied this provision to all foreign corporations that could benefit from a dual resident corporation's net operating loss, whether or not the foreign corporation's earnings are or will be subject to U.S. tax, for two reasons.

First, Congress believed that this application is fair: Congress was not aware of a case where the use of one company's deduction by two other companies each of which is resident in only one jurisdiction makes sense as a matter of tax policy. Second, Congress was aware of arguments that denying loss-sharing only when the income protected from foreign tax was not or would not be subject to U.S. tax discriminated against foreign-owned U.S. corporations. The Act's provision will apply to losses shared with foreign corporations whose earnings will be subject to U.S. tax (which are typically U.S.-controlled) as well as to losses shared with foreign corporations whose earnings are never subject to U.S. tax (which are typically foreign-controlled). Congress was aware that some have attempted to argue that the provision discriminates against foreign-controlled U.S. entities by somehow imposing on those entities some requirement for loss-sharing not imposed on U.S.-controlled U.S. entities. Congress found no merit in this argument. If this provision somehow is found to conflict with any treaty, the provision is to be effective notwithstanding the treaty.

Effective Date

This provision is effective for taxable years beginning after 1986. Carryforwards attributable to losses incurred in years beginning prior to 1987 by a dual resident corporation are available to offset income that another member of the affiliated group earns in years beginning after 1986. For example, a dual resident corporation incurred a $100 net operating loss for United States purposes in 1986, its first year of operation, and it shared that loss with a foreign corporation. The only other member of its U.S. consolidated group earned $50 in 1986. All these corporations use the calendar year as a taxable year. In 1987, the $50 loss carryforward is available for use against 1987 income of the dual resident corporation or the other member of the U.S. affiliated group.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $72 million in 1987, $124 million in 1988, $130 million in 1989, $138 million in 1990, and $148 million in 1991.

F. Foreign Currency Exchange Rate Gains and Losses (Sec. 1261 of the Act and secs. 1092, 1256, and new secs. 985-989 of the Code)[1]

Prior Law

Background

When a U.S. taxpayer uses foreign currency, gain or loss (referred to as "exchange gain or loss") may arise from fluctuations in the value of the foreign currency relative to the U.S. dollar. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

The principal issues presented by foreign currency transactions relate to the timing of recognition, the character (capital or ordinary), and the geographic source or allocation (domestic or foreign) of exchange gains or losses. Another area of concern is the treatment of a U.S. taxpayer that operates abroad through a branch or subsidiary corporation that keeps its books and records in a foreign currency; here, the issues relate to the method used to translate results recorded in a foreign currency into U.S. dollars.

Foreign currency transactions

Most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the Internal Revenue Service ("IRS"). Additional rules of limited application were provided by Treasury regulations and, in a few instances, statutory provisions.

Foreign exchange gain or loss could arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss could also arise where foreign currency was acquired for personal use.[2] Under the so-called "separate transactions principle," both the courts and the IRS required that exchange gain or loss be separately accounted for, apart from any gain or loss attributable to an underlying transaction.[3]

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 321; H.Rep. 99-426, pp. 449-481; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 621; S.Rep. 99-313, pp. 433-474; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 659-678 (Conference Report).

[2] *See* Rev. Rul. 74-7, 1974-1 C.B. 198 (the IRS ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use—while traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency).

[3] Although the law on this point was fairly well settled, there was a contrary line of older cases that provided authority for determining overall gain or loss by aggregating exchange gain or loss and gain or loss from the underlying transaction. *Compare National-Standard Co., 80 T.C. 551 (1983), aff'd,* 749 F.2d 369 (6th Cir. 1984) (where the taxpayer and the IRS stipulated that the separate transactions principle applied) *with Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926) (where the U.S. Supreme Court determined that no net income was realized where the overall transaction generated a loss that exceeded an exchange gain on repayment of a for-

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Debt denominated in a foreign currency

Treatment of debtors

In general.—A taxpayer may borrow foreign currency to use in a trade or business (e.g., to satisfy an account payable) or to make an investment in a foreign country. At maturity of a loan denominated in a foreign currency, typically, the taxpayer must obtain units of the foreign currency—in exchange for U.S. dollars—to repay the loan. If the foreign currency increases in value before the repayment date, the amount of U.S. dollars required to retire the debt exceeds the U.S.-dollar value of the foreign currency originally borrowed, and the taxpayer suffers an economic loss. Conversely, if the foreign currency depreciates in value, the taxpayer discharges the debt at a reduced cost (because fewer U.S. dollars are needed to obtain the number of units of foreign currency originally borrowed); here, the taxpayer realizes an economic gain.

Example (1).—Assume a U.S. taxpayer borrows 24 million Japanese yen when the rate of exchange (or "spot" rate) is 240 yen per U.S. dollar (i.e., the yen has a U.S. dollar value of about $.004167). Thus, the U.S.-dollar value of the loan proceeds is $100,000. At maturity of the loan, the borrower must repay 24 million yen, without regard to fluctuations in the yen:dollar exchange rate.

If the exchange rate on the date of repayment were 220 yen per dollar (i.e., if the U.S.-dollar value of the yen increased to approximately $.004545), there would be a loss of $9,091 because $109,091 would be needed to purchase 24 million yen.[4]

If the exchange rate on the date of repayment were 260 yen per dollar (i.e., if the U.S.-dollar value of the yen fell to approximately $.003846), there would be a gain of $7,692 because only $92,308 would be required to obtain 24 million yen.

Character of exchange gain or loss on repayment.—Characterization of exchange gain or loss as capital or ordinary depended on whether the discharge of a foreign-currency denominated obligation was viewed as the disposition of a "capital asset"[5] in a sale or exchange.

There is a substantial body of case law under which the use of property to discharge an obligation is treated as a sale or exchange of the property.[6] Under this line of cases, realized gain or loss is measured by the difference between the adjusted basis of the property transferred and the principal amount of the obligation. In

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eign currency loan). There are two well recognized exceptions to the separate transactions principle: (1) a dealer in foreign exchange can use the lower of cost or value to determine foreign currency inventory (Rev. Rul. 75-104, 1975-1 C.B. 18), and (2) a foreign branch of a U.S. taxpayer may translate unremitted foreign currency denominated profits into dollars at the exchange rate in effect at the end of a taxable year, as described below.

[4] $.004545 x 24 million = $109,091.

[5] The term "capital asset" includes all classes of property not specifically excluded by Section 1221 of the Code. Foreign currency generally falls within the definition of a capital asset; however, under *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), property that satisfies the literal language of section 1221 of the Code is not considered a capital asset if the property is used by a taxpayer as an integral part of a trade or business.

[6] *See, e.g., Kenan* v. *Commissioner*, 114 F.2d 217 (2d Cir. 1940) (where property was transferred in satisfaction of a legatee's claim against an estate); *Rogers* v. *Commissioner*, 103 F.2d 790 (9th Cir.), *cert. denied*, 308 U.S. 580 (1939) (where property was transferred in return for cancellation of a note representing part of the purchase price); Rev. Rul. 76-111, 1976-1 C.B. 214. *See also United States* v. *Davis*, 370 U.S. 65 (1962) (where property was transferred to a spouse to discharge marital claims; this particular result was reversed by the Deficit Reduction Act of 1984).

light of this authority, because foreign currency is treated as property, the IRS took the position that the transfer of foreign currency to pay a debt constitutes a sale or exchange. Thus, in the IRS's view, capital gain or loss resulted, unless the foreign currency was used by the borrower as an integral part of its ordinary trade or business under the *Corn Products* doctrine.[7]

The Sixth Circuit Court of Appeals, as well as the U.S. Tax Court (with seven dissents), rejected the IRS's view that repayment of a foreign currency loan constitutes a sale or exchange.[8] The Sixth Circuit relied on a 1939 case in which the U.S. Supreme Court held that the repayment of a debt is not considered a sale or exchange as to the creditor because the debtor does not receive property in the transaction.[9]

In an earlier case, the Sixth Circuit characterized exchange gain as income from the discharge of indebtedness.[10] Business taxpayers took the position that they could rely on this decision to defer the recognition of an exchange gain on repayment of a loan, by electing to reduce the basis of depreciable property by a corresponding amount (under prior law sections 108 and 1017 of the Code), while immediately claiming exchange losses on similar transactions.

Finally, the borrowing and repayment of a foreign currency was analogized to a "short sale," an analysis that supports capital gain or loss treatment unless the *Corn Products* doctrine applies.[11] In a short sale, the taxpayer sells borrowed property and later closes the short sale by returning identical property to the lender. Under section 1233(a) of the Code, gain or loss (computed by comparing the adjusted basis of the property used to close the short sale with the amount realized when the borrowed property was sold) is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer.

Source rules.—The source of an exchange gain or loss was important because of its impact on the calculation of the foreign tax credit limitation (as described more fully below, the amount of the credit was limited to the portion of U.S. tax liability that was attributable to foreign-source taxable income). Sections 861, 862, and 863 of the Code, and the accompanying regulations, provided rules for allocating income or gain to a domestic or a foreign source. Under the "title passage" rule, gain from the sale of personal property generally was treated as foreign source if the property was sold outside the United States; however, the resourcing rule of prior law section 904(b)(3)(C) of the Code could apply to recharacterize a taxpayer's foreign source capital gain as domestic source gain for purposes of the foreign tax credit limitation.[12]

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[7] *See* Rev. Rul. 78-396, 1978-2 C.B. 114; Rev. Rul. 78-281, 1978-2 C.B. 204; G.C.M. 39294 (June 15, 1984).

[8] *National-Standard Co.*, 749 F.2d 369 (6th Cir. 1984), *aff'g* 80 T.C. 551 (1983).

[9] *Fairbanks* v. *United States*, 306 U.S. 436 (1939), *aff'g* 95 F.2d 794 (9th Cir. 1938) (the result in the case was reversed by statute).

[10] *Kentucky & Indiana Terminal Railroad Co.* v. *United States*, 330 F.2d 520 (6th Cir. 1964). *See also Gillin* v. *United States*, 423 F.2d 309 (Ct. Cl. 1970).

[11] *See National-Standard*, 80 T.C. at 567-568 (Judge Tannenwald's dissent).

[12] Section 904(b)(3)(C) was designed to limit abuse of the "title passage" rule (i.e., the making of sales abroad solely to generate foreign source gains and thereby increase the foreign tax

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Losses from the disposition of capital assets or assets described in section 1231(b) of the Code (relating to property used in a trade or business) were apportioned between foreign and domestic income by reference to the source of the income to which the property ordinarily gave rise (Treas. reg. sec. 1.861-8(e)(7)). Otherwise, losses were generally allocated and apportioned between foreign and domestic gross income (e.g., on the basis of the location of the taxpayer's property).

Treatment of creditors

If a taxpayer made a loan of foreign currency and was repaid with appreciated or depreciated currency, the taxpayer realized exchange gain or loss on the repayment.[13] Under section 1271 of the Code, amounts received by the holder on retirement of a debt instrument generally are treated as received in a sale or exchange. The character of the gain or loss depends on whether the debt instrument constitutes a capital asset in the hands of the holder.

Accounts payable or receivable

A U.S. taxpayer may agree to make or receive payment in a foreign currency for the sale of goods or the performance of services, thereby creating a foreign currency denominated account payable or account receivable, respectively. Foreign exchange gain or loss will arise if the value of the foreign currency appreciates or depreciates before the account is settled. Under the case law, exchange gain or loss arising from accounts payable or receivable was recognized at the time of payment.[14]

Character.—There is no legal difference between borrowing foreign currency from a third party or borrowing, in effect, by obtaining credit from a seller.[15] Consistent with the *Corn Products* doctrine, exchange gain or loss attributable to the settlement of a trade payable or receivable was generally characterized as ordinary income or loss.[16]

Source of exchange gain or loss on accounts payable or receivable.—Applicable rules generally sourced income from the sale of in-

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credit limitation), and applied unless (1) the property was sold in a country in which the taxpayer derived more than 50 percent of its gross income for the three-year period preceding the sale; (2) personal property was sold by an individual in a foreign country where the individual was resident; (3) shares in a corporation were sold by a corporate taxpayer in the country in which the issuer was resident, and the issuer derived more than 50 percent of its gross income from that country during the preceding three-year period; or (4) a foreign tax of ten percent or more was paid on the sale or exchange.

[13] *See KVP Sutherland Paper Co.* v. *United States*, 344 F.2d 377 (Ct. Cl. 1965). In *KVP Sutherland*, the court found three recognition events in a loan transaction: (1) the exchange of foreign currency for a note, (2) the receipt of foreign currency on repayment, and (3) the conversion of the foreign currency received on repayment to U.S. dollars.

[14] *See Bennett's Travel Bureau, Inc.*, 29 T.C. 198 (1956) (where the taxpayer accrued a deduction for accounts payable in Norwegian kroner but, in a later year, settled the account at less than the U.S.-dollar amount it had deducted); *Foundation Co.*, 14 T.C. 1333 (1950) (where the taxpayer performed services in Peru and accrued Peruvian soles, and the currency's value at the time of payment was lower than when the income was accrued).

[15] *See American-Southeast Asia Co.*, 26 T.C. 198, 201 (1956) (where the U.S. Tax Court considered this point).

[16] *See Church's English Shoes, Ltd.*, 24 T.C. 56 (1955), *aff'd per curiam*, 229 F.2d 957 (2d Cir. 1956) (where the taxpayer imported goods on credit, the purchase of foreign currency to settle the account payable was viewed as part of the taxpayer's ordinary business, and, thus, an exchange gain was taxable as ordinary income). *See also* I.R.C. sec. 1221(4) (an account receivable acquired for services rendered or sales of property in the ordinary course of business is excluded from the definition of a capital asset).

ventory under the title passage test. Similarly, income from the performance of services was sourced by reference to the place where the services were performed. As noted above, losses were generally allocated and apportioned between domestic and foreign sources. In view of the separate transactions principle, however, it was unclear whether exchange gain or loss on settlement of an account relating to the sale of inventory or the performance of services would be sourced or allocated like the income or loss from the underlying sale or performance.

Interest on foreign currency denominated debt

Rules of general application.—Normally, a debt instrument is issued at a price approximately equal to the amount that will be received by the lender at maturity, and the return to the lender is entirely in the form of periodic interest payments. In the case of a debt instrument that is issued at a discount, the issue price is less than the amount to be repaid to the lender, and the lender receives some or all of the return in the form of price appreciation. The original issue discount ("OID") is functionally equivalent to an increase in the stated rate of interest, i.e., OID compensates the lender for the use of the borrowed funds. If a debt instrument is issued at a premium, the issue price is more than the amount to be repaid to the lender.

In general, interest was includible in the lender's income (and deductible by the borrower) when paid or accrued. The issuer of an OID instrument was allowed deductions for, and the holder of the instrument was required to include in income, the daily portions of OID determined for each day of the taxable year the instrument was held (secs. 163(e) and 1272). If an instrument was issued at a premium, the premium was treated as income to the issuer that had to be prorated or amortized over the life of the instrument (Treas. reg. sec. 1.61-13(c)). The holder of an instrument issued at a premium could elect to deduct equal annual amounts over the life of the obligation (sec. 171).

Amortization of OID or bond premium.—The rules for amortizing OID parallel the manner in which interest would accrue on interest-paying nondiscount bonds (under the constant yield method).[17]

OID was allocated daily over the term of a debt instrument through adjustments to the issue price at the end of each accrual period in a series (generally, the series of six-month periods leading up to the maturity date). The adjustment to the issue price at the end of each accrual period was determined by multiplying the issue price (as increased by prior adjustments) by the instrument's yield to maturity, and then subtracting the interest actually payable during the accrual period. Each day in an accrual period was allocated an amount of OID equal to its ratable share of the adjustment to the issue price for that period. Although the economic arguments underlying the treatment of OID are equally applicable to premium, taxpayers were not required to use the constant yield method to amortize premium.

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[17] Essentially, the borrower is deemed to pay the lender interest based on the actual yield to maturity times the issue price of the obligation. The deemed interest is deductible by the borrower and includible in the income of the lender, and the lender is treated as lending the same amount back to the borrower. Thereafter, the borrower is viewed as paying the deemed rate of interest on the unpaid interest (periodically recomputed as above) as well as on the issue price.

Prior law was unclear regarding the treatment of discount or premium on foreign currency denominated obligations. For example, it was unclear whether OID was computed by reference to the U.S.-dollar value of a foreign currency at the time an obligation was issued, or was computed in terms of the foreign currency and translated into dollars at the average value in each period that OID accrued.

Measurement of interest income and deductions in deferred payment transactions.—Prior to 1984, the OID provisions did not apply to an obligation issued for nonpublicly traded property where the obligation itself was not publicly traded. The principal reason for this exception was the perceived difficulty in determining the value of nonpublicly traded property, and hence the issue price of (and the amount of OID implicit in) the obligation. Congress addressed this valuation problem by providing objective rules that prescribe an issue price for an obligation issued for nonpublicly traded property (sec. 1274).

Section 1274 performed two roles: (1) testing the adequacy of stated interest, and, where stated interest is inadequate, recharacterizing a portion of the principal amount as interest, and (2) prescribing the issue price. If the prescribed issue price is less than the debt instrument's stated redemption price at maturity, the differential was treated as OID. These calculations were made by reference to the "applicable Federal rate" (generally, the average yield on marketable obligations of the U.S. government with a comparable maturity, referred to as the "AFR").

Under a literal reading of section 1274, an obligation issued for foreign currency was subject to the rules for deferred payment transactions. Proposed regulations provided that, in the case of a debt instrument the repayment of which is denominated in a foreign currency, the AFR was to be the analogous foreign currency rate of interest (Prop. Treas. reg. sec. 1.1274-6(c)).

Below market loans.—Under section 7872, certain below market loans (including any extension of credit) were treated as economically equivalent to loans bearing interest at the AFR, coupled with a payment by the lender to the borrower sufficient to fund the payment of interest by the borrower. Proposed regulations provided that, for purposes of applying these rules to a foreign currency denominated loan, a market rate of interest appropriate to the currency was used rather than the AFR, although the proposed regulations left open the issue of how the imputed transfer from the borrower to the lender was to be treated (Prop. Treas. reg. sec. 1.7872-11(f)).

Treatment of market discount.—A market discount bond is an obligation that is acquired for a price that is less than the principal amount of the bond (or less than the amount of the issue price plus accrued OID, in the case of an OID bond). Market discount generally arises when the value of a debt obligation declines after issuance, typically, because of an increase in prevailing interest rates or decline in the creditworthiness of the issuer. Gain on disposition of a market discount bond is recognized as interest income, to the extent of accrued market discount (generally computed under a linear formula, although a taxpayer can elect to use the constant yield method described above). Accrued market discount is not treated as interest for purposes of withholding at source, information reporting requirements, or such other purposes as the Secretary may specify in regulations.

Thirty-percent withholding.—In certain cases, U.S.-source interest income received by a foreign person was subject to a flat 30-percent tax on the gross amount paid, subject to reduction in rate or exemption by tax treaties to which the United States is a party (secs. 871(a) and 881).[18] The tax was generally collected by means of withholding by the person making the payment to the foreign recipient (secs. 1441 and 1442). The 30-percent tax was inapplicable if the interest was effectively connected with a U.S. trade or business of the foreign recipient; instead, the income was reported on a U.S. income tax return and taxed at the rates that apply to U.S. persons. The 30-percent tax was inapplicable to interest paid by a U.S. borrower on certain portfolio debt and other investments.

Allocation of U.S. taxpayer's interest expense.—A U.S. taxpayer's deduction for interest expense was generally apportioned between domestic and foreign source gross income in proportion to the borrower's domestic and foreign assets, or, within limits, domestic and foreign source gross income (Treas. reg. sec. 1.861-8(e)(2)).

Hedging transactions

A U.S. taxpayer can "hedge" against changes in the dollar value of foreign currency denominated assets and liabilities.

Example (2).—In example (1), above, where a U.S. taxpayer borrows 24 million yen when the exchange rate is 240:1, the borrower could hedge against a potential exchange loss (i.e., protect itself against possible appreciation in the value of the yen to be repaid) by entering into a "forward contract" (defined below) to purchase, at the maturity of the loan, 24 million yen at a predetermined exchange rate (or "forward" rate).

Assume that the forward and spot rates are the same (because there is no interest rate differential between the yen and dollar on the day the forward contract is entered into). If the yen appreciated to 220:1 as of the repayment date, the borrower could obtain yen under the forward contract at the 240:1 rate and save $9,091 (the additional $9,091 that would have been required to purchase 24 million yen at the spot rate on the repayment date).

If the yen depreciated to 260:1, the borrower would still be obligated to purchase yen at the more expensive forward rate, although the obligation could be terminated by making a cash payment.

The U.S. tax consequences of a transaction that was undertaken to hedge foreign exchange exposure turned, in large part, on (1) the nature of the financial product used to effect the hedge, and (2) whether the hedging transaction related to the taxpayer's own business operations or the business operations of an affiliate. Further, different tax rates could apply to the positions included in a hedging transaction, with the result that a transaction that produced no economic gain or loss could result in an after-tax profit or loss.

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[18] The 30-percent withholding tax also applies to other fixed or determinable annual or periodical income from U.S. sources.

Description of certain financial products

A variety of financial products are used to reduce the impact of exchange rate fluctuations on foreign-currency denominated assets or liabilities.

Forward contracts.—Trading in foreign currency is conducted in an informal interbank market through negotiated forward contracts. A forward contract calls for delivery or purchase of a specified amount of foreign currency at a future date, with the exchange rate fixed when the contract is made. Forward exchange rates are determined by reference to interest rate differentials in the interbank deposit market. The currency with the lower interest rate trades at a higher forward price than spot price; the difference is referred to as "forward premium." The difference between the spot price and the forward price of the currency with the higher interest rate is referred to as a "forward discount."

Example (3) (pricing a forward contract).—Assume that the three-month deposit rate for Deutsche marks is 8 percent compounded quarterly (for a three-month yield of 2 percent), and the three-month deposit rate for U.S. dollars is 10 percent compounded quarterly (for a three-month yield of 2-1/2 percent). The spot rate for Deutsche marks is 2.1 (i.e., DM2.1=$1). If the forward exchange market is perfectly efficient, the three-month forward exchange rate for Deutsche marks should be 2.0898, determined according to the following formula:

$$\frac{\text{DM}2.1^{1} \times 1.02^{2}}{\$1 \times 1.025^{2}} = 2.0898$$

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[1] The spot rate.

[2] One plus the interest rate.

Thus, a taxpayer who requires Deutsche marks in three months time (e.g., to settle an account payable) can limit the risk of exchange gain or loss either by purchasing Deutsche marks at the spot rate and depositing them, or by entering into a forward purchase contract, with approximately the same results in either case.

Regulated futures contract.—A futures contract is a standardized forward contract to sell or purchase a specified amount of foreign currency during a designated month in the future. A regulated futures contract ("RFC") was defined for purposes of section 1256 of the Code (discussed below) as a contract that is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission (or any board of trade or exchange approved by the Treasury Department), and that is "marked to market" (defined below in the discussion of section 1256 of the Code) under a cash settlement system of the type used by U.S. futures exchanges to determine the amount that must be deposited due to losses, or the amount that may be withdrawn in the case of gains (as the result of price changes with respect to the contract). The utility of futures contracts as hedging tools is limited, primarily because contracts in excess of 12 months are difficult to obtain.

A variety of foreign currency futures (covering, for example, Deutsche marks, British pounds, and Japanese yen) are traded on the New York Futures Exchange and the International Monetary Market of the Chicago Mercantile Exchange, among others.

Foreign currency options.—A foreign currency option is a contract under which the "writer" grants the "holder" the right to purchase or sell the underlying currency for a specified price during the option period. The consideration (or premium) for option rights is paid at acquisition, and the holder has no further obligations under the option unless or until the option is exercised. Foreign currency options are written by banks, as well as traded publicly on exchanges such as the Chicago Mercantile Exchange and the Philadelphia Stock Exchange.

Example (4).—On the facts of example (2), above, instead of entering into a forward contract, the borrower could acquire an option to purchase 24 million yen at 240 yen per dollar, thus eliminating (at the cost of the option premium) the potential for loss due to a future rise in the dollar price of yen. On the other hand, the borrower would not be contractually bound to exercise the option. If the spot price of yen on or before the loan maturity date were low enough, the borrower might buy 24 million yen at the spot rate, and let the option expire unexercised.

Parallel or back-to-back loans.—In a back-to-back loan, a taxpayer lends U.S. dollars to a foreign person; contemporaneously, the foreign person lends foreign currency of equal value to the U.S. taxpayer. The terms of the loan agreements are substantially identical, other than the interest rates, and both loans mature on the same date. In a parallel loan, the borrowers and lenders are separate but related entities (e.g., a U.S. parent corporation lends dollars to the U.S. subsidiary of a French corporation, and the French corporation lends French francs to the French subsidiary of the U.S. parent corporation).

Example (5).—Assume that a U.S. taxpayer owns a foreign currency denominated bond due to mature in 10 years. The taxpayer would prefer to hedge its currency risk on this bond but cannot find buyers willing to enter into suitable fixed price contracts to buy the bond proceeds for future delivery. Instead, the taxpayer might hedge by borrowing the currency under a loan with repayment dates and amounts comparable to the payment dates of the bond. In certain cases, a back-to-back or parallel loan might represent the most desirable means of borrowing for this purpose.

Parallel and back-to-back loans may present legal issues involving the secured transactions and insolvency laws of several jurisdictions, and a party to such a transaction could be required to repay a loan even if the other party is prevented from repaying the corresponding loan (e.g., because of a bankruptcy proceeding).

Currency swaps and interest rate swaps.—Currency swaps were developed as an alternative to back-to-back loans. A currency swap generally involves an exchange of U.S. dollars for foreign currency at the spot rate, coupled with an agreement to reverse the transaction on a future date at the original exchange rate. A swap can be structured so that there is no actual exchange of currencies; the parties to the swap can simply obtain currency in the spot market and agree to make payments to each other. A currency swap avoids the legal issues presented by parallel or back-to-back loans because each party's obligation to deliver currency is conditioned on performance by the other party.

In an interest rate swap, two parties agree to service each others' debt obligations to third parties. For example, one borrower may incur fixed-rate debt and another floating rate debt, then each will pay the other periodic amounts determined by reference to the other's liability to its lender. Interest rate swaps generally are used to match interest rate exposures on the financial asset and financial liability sides of a balance sheet. Cross-currency interest rate swaps (mutual agreements to service equivalent amounts of debt denominated in different currencies) are useful for matching both interest and currency exposures when a taxpayer's balance sheet contains foreign currency denominated financial assets or liabilities.

Although in an interest rate swap, the swap payments are measured by interest payments, they were not viewed as interest because they are not paid as compensation for the use or forbearance of money.[19]

There was a question under prior law as to whether swap payments made by a U.S. taxpayer constitute U.S.-source "fixed or determinable annual or periodical income," and, thus, were subject to 30-percent withholding. A related issue was whether an exemption from withholding was available under an income tax treaty to which the United States is a party. It was argued that swap payments under an interest rate swap were exempt on the ground that swap payments constitute: (1) "industrial and commercial profits" not attributable to a permanent establishment, or (2) in the case of the U.K. and several other treaties, "other income" that is taxable only by the country of the recipient's domicile.[20]

Application of provisions relating to tax straddles

Specific statutory rules prevented the use of "straddles" to defer income or to convert ordinary income (or short-term capital gain) to long-term capital gain. In general, a tax straddle was defined as offsetting "positions" with respect to personal property (sec. 1092(c)). The term position was generally defined as an interest (including a futures or forward contract) in personal property of a type that is actively traded (sec. 1092(d)). Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property.

By their terms, the tax straddle rules applied to most transactions undertaken to hedge foreign exchange exposure, unless the transaction generated only ordinary income or loss (and otherwise satisfied the requirements of the statutory hedging exemption described below).

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[19] *See* Rev. Rul. 87-5, 1987-3 I.R.B. 6; Notice 87-4, 1987-3 I.R.B. 7.

[20] *See* Rev. Rul. 87-5, 1987-3 I.R.B. 6 (holding that a cross border U.S. dollar denominated interest rate swap between a U.S. person and a Netherlands bank resulted in industrial and commercial profits exempt from U.S. tax under the U.S.-Netherlands Income Tax Convention).

Loss deferral rule.—If a taxpayer realized a loss on the disposition of one or more positions in a straddle, the amount of the loss that could be deducted was limited to the excess of the loss over any unrecognized gain in offsetting positions (sec. 1092(a)). In addition, taxpayers were required to capitalize expenditures incurred to purchase or carry property that was part of a straddle, except to the extent of income received with respect to the property (sec. 263(g)).

Taxpayers questioned whether a currency swap constituted a position in a straddle if the risk of loss on a foreign currency loan or borrowing was diminished thereby. If a currency swap were viewed as a straddle position, the capitalization requirement would apply, and the swap payments would be deductible only to the extent of payments received from the other party to the swap unless the hedging exemption (described below) applied.

Mark-to-market rules.—An RFC or a nonequity option that is traded on (or subject to the rules of) a qualified board of trade or exchange (including a foreign currency option) and that is held by a taxpayer at year-end was treated as if it were sold for its fair market value on the last business day of the year (sec. 1256(a)(1)). Positions that were subject to mark-to-market treatment were referred to as section 1256 contracts. Any gain or loss on a section 1256 contract was generally treated as 40-percent short-term capital gain or loss and 60-percent long-term capital gain or loss. For purposes of these rules, a foreign currency forward contract was treated as a section 1256 contract if the currency was one in which positions were also traded through RFCs, if the contract was traded in the interbank market, and if the contract was entered into at an arm's length price determined by reference to the price in the interbank market (sec. 1256(g)).

Mixed straddles.—In general, the loss deferral rule applied to a straddle composed of both section 1256 contracts and positions that were not marked-to-market. The section 1256 contracts in a mixed straddle were excluded from the mark-to-market, 60/40 characterization rules if the taxpayer designated the positions as a mixed straddle by the close of the day on which the first section 1256 contract was acquired (or such earlier time as the Secretary was authorized to require).

Under prior law, some taxpayers questioned whether an obligor's interest in a foreign currency denominated loan constituted a position in personal property for purposes of the tax straddle rules. If the interest was deemed to be a position and was hedged by a section 1256 contract, the tax consequence under prior law could be quite harsh:

Example (6).—Assume a foreign currency denominated borrowing is treated as a position and is offset by a forward purchase contract that is subject to the mark-to-market rule (which would occur if no mixed straddle election were made). Assume further that the taxpayer uses the loan proceeds to make an investment. If the forward contract is marked to market at a loss (because the currency depreciated), the loss would be deferred until the offsetting gain attributable to the loan is recognized. If the taxpayer realizes capital gain on the repayment of the loan, the gain would correspond to the 60/40 loss attributable to the forward contract. Assuming the capital gain is short-term (because the currency was acquired shortly before it is used to repay the loan), the 60/40 loss could result in the conversion of unrelated long-term capital gain to short-term capital gain. This would occur because only 40 percent of the short-term capital gain would be offset by loss on the forward contract; the other 60 percent of the loss on the forward contract would be netted against the taxpayer's unrelated long-term capital gain. The end result is a net short-term gain equal to the amount of what would have been long-term gain from the unrelated transaction. In this case, the straddle produces an adverse tax result, even though it is a wash from an economic perspective.

A taxpayer could avoid these results by making a mixed straddle election and foregoing mark-to-market and 60/40 gain treatment. A taxpayer might fail to make a timely election, however, because of uncertainty in determining whether positions in foreign currency were part of a straddle, or because offsetting positions were established inadvertently.

Termination of rights under a forward contract.—Gain or loss from the cancellation, lapse, expiration, or other termination of a position (as defined in section 1092(d)) with respect to property that would be a capital asset was treated as capital gain or loss, except in the case of the retirement of a debt instrument (sec. 1234A). Thus, gain or loss realized on settlement of a foreign-currency forward contract would be capital gain or loss unless the *Corn Products* doctrine applied, regardless of the manner in which the contract was terminated.

Hedging exception.—Certain hedging transactions were exempt from the loss deferral, mark-to-market, and capitalization rules (secs. 1092(e) and 1256(e)). For purposes of this exception, a hedging transaction generally was defined as a transaction that is executed in the normal course of a trade or business primarily to reduce certain risks, and results only in ordinary income or loss. Under a special rule for banks (as defined in section 581), a bank's transactions did not need to satisfy the primary purpose requirements applicable to other taxpayers. This hedging exception applied to a transaction that reduces the risk of (1) price changes or foreign currency exchange rate fluctuations with respect to property held or to be held by the taxpayer, or (2) interest rate or price changes, or foreign currency exchange rate fluctuations with respect to borrowings or obligations of the taxpayer. For purposes of these rules, a hedging transaction had to be clearly identified before the close of the day the transaction was entered into.

Taxpayers claimed uncertainty in determining whether the hedging exemption applied because of the requirements that the transaction be entered into in the normal course of a trade or business and result only in ordinary income or loss, which requirements implicated the *Corn Products* doctrine. Consider the case of a U.S. corporation that satisfies a need for U.S. dollars by putting together a "synthetic" dollar package—i.e., borrowing foreign currency for immediate conversion to U.S. dollars, and then hedging the foreign currency loan (by a forward exchange contract, for example). Assume that the loan proceeds are used for general corporate purposes in the United States. A U.S. corporation might do this because it finds it less expensive than raising dollars directly. Some taxpayers took the position that the hedging exemption applied to this situation. However, it was unclear whether such a transaction could be viewed as entered into in the normal course of a trade or business, or whether the gain or loss on repayment of the foreign currency loan would be viewed as ordinary income or loss.[21]

Related provisions: short sale rules of section 1233.—Prior law provided rules that were designed to eliminate specific devices in which short sales could be used to transform short-term capital gain into long-term capital gain, or long-term capital loss into short-term capital loss (sec. 1233(b) and (d)). The rules were stated to apply to stock, securities, and commodity futures, but not to hedging transactions in commodity futures (sec. 1233(e)). Under these rules, if a taxpayer held property for less than the period required for long-term capital gain treatment, and sold short substantially identical property, any gain on closing the short sale was considered short-term capital gain and the holding period of the substantially identical property generally was considered to begin on the date of the closing of the short sale (sec. 1233(b)).

There were several cases that supported the position that section 1233(b) was inapplicable to the sale of a foreign currency forward contract.[22] The IRS, however, took a contrary view.[23]

Hedges relating to foreign subsidiaries

Under the case law, the *Corn Products* doctrine was applied to hedging transactions only if the hedge related to the taxpayer's "own" day-to-day business operations. Thus, a hedging transaction with respect to the separate operations of a foreign subsidiary corporation was treated as falling without the doctrine.[24]

Foreign currency translation

Under prior law, a taxpayer operating abroad was permitted to maintain the books and records of the operation in a foreign currency. The method of translating the results of the taxpayer's foreign operation turned on whether the activity was conducted through a branch or through a subsidiary corporation. Additional requirements were imposed if the taxpayer operated through a subsidiary that was a "controlled foreign corporation" (generally, a foreign corporation more than 50 percent of the voting stock of which was owned by U.S. shareholders, referred to as a "CFC").

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[21] *Compare National-Standard Co.*, 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984), *with* G.C.M. 39294 (June 15, 1984).

[22] *American Home Products Co.* v. *United States*, 601 F.2d 540 (Ct. Cl. 1979); *Carborundum Co.*, 74 T.C. 730 (1980).

[23] Technical Advice Memorandum 8016004 (December 18, 1979). Although a technical advice memorandum is not binding as precedent on the IRS or the courts, a technical advice memorandum is helpful in interpreting the law in the absence of clear authority.

[24] *International Flavors & Fragrances*, 62 T.C. 232 (1974), *rev'd and rem'd*, 524 F.2d 357 (2d Cir. 1975), *on remand*, 36 T.C.M. 260 (1977) (taxpayer sold British pounds short to hedge net asset position of U.K. subsidiary); *The Hoover Co.*, 72 T.C. 206 (1979) (taxpayer entered into forward contracts to offset potential decline in value of stock in a foreign subsidiary), *nonacq.*, 1980-1 C.B. 2 (the nonacquiescence relates to the court's holding that Hoover's sale of a forward sale contract for foreign currency shortly before the time set for performance—but after the currency was devalued—resulted in long-term capital gain; the IRS's concern was based on the fact that short-term capital gain would have resulted if the taxpayer had made delivery under the contract by purchasing foreign currency at the spot rate immediately before the delivery).

Prior law did not prescribe criteria for use in determining when it is appropriate to record the results of a foreign operation in a foreign currency. Further, for the most part, the method used to translate foreign currency results into U.S. dollars was left to the taxpayer's discretion. The available translation methods could produce substantially different U.S. tax consequences.

Branches

A foreign branch that maintained a separate set of books in a foreign currency could use either a "profit and loss" or a "net worth" method to determine U.S. taxable income attributable to the branch operation.[25]

Under the profit and loss method, the net profit computed in the foreign currency was translated into dollars at the exchange rate in effect at the end of the taxable year. If the branch made remittances during the year, these amounts were translated into U.S. dollars at the exchange rate in effect on the date remitted, and only the balance of the profit, if any, was translated at the year-end exchange rate.

Under the net worth method, U.S. taxable income was generally defined as the difference between the branch's net worth at the end of the prior taxable year and at the end of the current taxable year. Under this method, the branch's balance sheet was translated into U.S. dollars. In general, the values of current assets and liabilities were translated at the year-end exchange rate, and fixed (long-term) assets and liabilities were translated at the exchange rate in effect on the date the asset was acquired or the liability incurred (the "historical rate"). The translation of an item at its historical rate deferred recognition of exchange gain or loss. A remittance was translated at the exchange rate in effect on the date of remittance, and then added to the U.S.-dollar amount computed by comparing year-end balance sheets.

The choice of a method for translating the income of a branch was viewed as a method of accounting, and, thus, could not be changed without the consent of the Secretary.[26] The profit and loss and net worth methods produced different results, primarily because changes in the dollar values of current assets and liabilities were taken into account annually under the net worth method, but not under the profit and loss method.

When a foreign branch remitted currency in excess of the current year's profit, the basis of the excess amount had to be determined in order to calculate exchange gain or loss. Prior law did not provide explicit rules for calculating exchange gain or loss on remittances.

Distributions from foreign corporations

A domestic corporation was subject to tax on its worldwide income. Foreign corporations generally were taxed by the United States only on income that was effectively connected with a U.S.

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[25] *See* Rev. Rul. 75-107, 1975-1 C.B. 32 (relating to the profit and loss method); Rev. Rul. 75-106, 1975-1 C.B. 31; Rev. Rul. 75-134, 1975-1 C.B. 33 (relating to the net worth method); Rev. Rul. 75-105, 1975-1 C.B. 29 (applying the net worth method to a bank).

[26] *See American Pad & Textile Co.*, 16 T.C. 1304 (1951), *acq.*, 1951-2 C.B. 1.

trade or business and on certain passive income from U.S. sources. As a result, under the general rules, income derived by a U.S. person through a foreign corporation operating abroad was not subject to tax unless and until the income was distributed to U.S. shareholders. An exception to the general rule of deferral was provided by the subpart F provisions of the Code (secs. 951-964), under which income from certain tax-haven type activities was taxed to certain U.S. shareholders of CFCs on a current basis.

Controlled foreign corporations

The "subpart F" income of a CFC was taxed to "U.S. shareholders" as a constructive dividend, to the extent of post-1962 earnings and profits (secs. 951 and 952(c)). The term "U.S. shareholder" was generally defined as a U.S. person who owns 10 percent or more of a CFC's voting stock (sec. 951(b)). "Subpart F" income generally included income from (1) related-party sales and services transactions through tax-haven base companies, (2) the insurance of U.S. risks, (3) shipping operations (unless the income was reinvested), (4) oil related activities, and (5) passive investments (sec. 952). A loan with a term of more than one year from a CFC to a related U.S. person generally was treated as an investment in U.S. property (sec. 956), with the result that the amount of the loan was treated as a constructive distribution to U.S. shareholders under the subpart F provisions (sec. 951(a)(1)(B)). A constructive distribution under subpart F included a pro rata portion of the CFC's exchange gain or loss.

Applicable Treasury regulations provided rules for translating a CFC's earnings and profits, subpart F income, and section 956 inclusions (Treas. reg. secs. 1.964-1(a)-(e)). Under the so-called "full subpart F" method, earnings and profits were calculated by (1) computing the CFC's profit or loss in the local currency, translating it to U.S. dollars at an "appropriate rate of exchange," and (2) adding to that amount the exchange gain or loss determined by comparing the U.S. dollar values of the CFC's year-opening and year-ending balance sheets (after backing out profit or loss and adding back distributions). Different balance sheet items were translated by reference to different rates, including, for some items, the so-called "appropriate rate of exchange." Generally speaking, this phrase meant a monthly average of the exchange rates in effect for the taxable year.[27]

Gain from sale or exchange of stock in certain foreign corporations

Gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. shareholder (as defined above) was recharacterized as dividend income, to the extent of the foreign corporation's post-1962 earnings and profits attributable to the period the stock sold was held by the shareholder while the corporation was a CFC

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[27] *See* Treas. reg. sec. 1.964-1(d)(2). If the value of the relevant currency fluctuated substantially during the year, the appropriate rate of exchange might be a weighted monthly average, depending on whether that rate more closely approximated the results of translating individual transactions at the exchange rates in effect when the transactions occurred. Also, for any transaction, a taxpayer could choose the actual rate of exchange for the date of the transaction. Treas. reg. sec. 1.964-1(d)(7)(iii).

(sec. 1248). For purposes of computing the section 1248 constructive dividend, a foreign corporation's earnings and profits were translated into U.S. dollars under the full subpart F method (described above) (Treas. reg. sec. 1.1248-2(d)).

Computation of foreign tax credit

In general, a credit against U.S. tax liability was allowed for foreign income taxes paid or accrued with respect to foreign-source income (sec. 901). The purpose of the foreign tax credit generally was stated to be to mitigate the effects of double taxation of income that is subject to tax by both the United States and a foreign government. The allowable foreign tax credit for a taxable year was limited to U.S. tax liability multiplied by a fraction, the numerator of which was foreign-source taxable income and the denominator of which was worldwide taxable income (sec. 904(a)).

For purposes of section 901 of the Code, foreign taxes were deemed paid with respect to dividends received by a U.S. corporation that owned at least 10 percent of the voting stock of the distributing foreign corporation (sec. 902). Generally, foreign taxes were also deemed paid with respect to Subpart F constructive dividends (sec. 960). Thus, these dividends carried with them a proportionate amount of the foreign taxes paid by the foreign corporation.

Direct credit

In the case of foreign taxes paid on income derived directly through branch operations, taxpayers generally were required to translate the foreign taxes into U.S. dollars at the exchange rate in effect on the date such taxes were paid or accrued.[28] If the amount of foreign taxes accrued differed from the amount paid, or if a foreign tax was refunded (in whole or in part), a taxpayer was required to notify the IRS, and redetermine the allowable credit for the taxable year (sec. 905(c)). The rule requiring an adjustment upon the payment of accrued foreign taxes was applied by comparing the U.S.-dollar value of the amount accrued to the U.S.-dollar value of the amount actually paid.[29]

If a foreign tax was refunded, under the case law, taxpayers were permitted to redetermine the allowable credit by translating the foreign refund into U.S. dollars at the rate of exchange in effect on the date of refund.[30]

Example (7) (refund of foreign tax).—Assume that a taxpayer pays a 10,000 Swiss franc tax when one franc is equal to $.50 (so the U.S.-dollar cost would be $5,000). In a later year, the entire 10,000 franc tax is refunded when one franc is equal to $.40 (so the U.S.-dollar value of the refund is only $4,000). Under the relevant authorities, a $1,000 tax would be eligible for credit even though the entire foreign tax was refunded.

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[28] Rev. Rul. 73-491, 1973-2 C.B. 268.

[29] *First Nat'l City Bank* v. *United States*, 557 F.2d 1379 (Ct. Cl. 1977); *Comprehensive Designers International Ltd.*, 66 T.C. 348 (1976); Rev. Rul. 73-506, 1973-2 C.B. 268.

[30] *American Telephone & Telegraph* v. *United States*, 430 F. Supp. 172 (S.D.N.Y. 1977), *aff'd*, 567 F.2d 554 (2d Cir. 1978); Rev. Rul. 58-237, 1958-1 C.B. 534.

Indirect credits

To calculate the amount of foreign taxes deemed paid under section 902 of the Code, the amount of foreign taxes paid with respect to the earnings out of which the distribution was made was multiplied by a fraction, the numerator of which was the amount of the dividend and the denominator of which was the amount of the after-tax accumulated profits out of which the dividend was paid (referred to as the "section 902 fraction") (sec. 902(a)).

To calculate the amount of foreign taxes deemed paid under section 960 of the Code, foreign taxes paid were multiplied by a fraction, the numerator of which was the income included under subpart F and the denominator of which was the CFC's earnings and profits (referred to as the "section 960 fraction").

Actual distributions.—In the case of an actual distribution, the regulations promulgated under section 902 of the Code provided that accumulated profits denominated in a foreign currency were translated into U.S. dollars at the exchange rate in effect on the date the dividend was distributed (Treas. Reg. sec. 1.902-1(g)(1)). Taxpayers were unable to compute accumulated profits by reference to the full subpart F method described above. Under applicable regulations, (*see* Treas. reg. sec. 1.902-1(g)(1)), accumulated profits could be computed under the "limited" subpart F method of Treas. reg. sec. 1.964-1(a)-(c), so-called because it measured profit and loss without reference to Treas. reg. secs. 1.964-1(d) and (e) (which translate earnings and profits into dollars and add to earnings and profits the annual exchange gain or loss attributable to certain current assets and liabilities of the corporation).

Under the authority of the *Bon Ami Co.* case,[31] the amounts of the dividend and the foreign taxes deemed paid were also translated at the exchange rate in effect on the date of distribution.[32] By its terms, section 905(c), which governed the treatment of variances—resulting from exchange rate fluctuations, for example—between taxes accrued and taxes paid, applied to taxes that were deemed paid; however, the use of the distribution date exchange rate to translate foreign taxes deemed paid effectively negated the requirement that a foreign tax be retranslated if accrued and paid on different dates.

Example (8).—Assume that a French subsidiary corporation has accumulated profits of 400 French francs before French tax and that a French tax of FF100 was paid. Assume further that the profits were earned, and the tax paid, when the French franc was worth $.20. Thus, a French tax with a value of $20 was paid with respect to $80 of income, resulting in an effective tax rate of 25 percent. If the after-tax earnings are distributed after the franc's value has fallen to $.10, the parent corporation would be deemed to have paid $10 of French tax ($30/$30 x $10).[33] If the franc's value rose to $.25, the parent corporation would be deemed to have paid $25 of French tax ($75/$75 x $25). In either case, the amount of French tax eligible for credit would equal 25 percent of the U.S.-dollar value of the accumulated profits before tax; however, the U.S.-dollar cost of the French tax paid would be understated or overstated, depending on whether the franc depreciated or appreciated against the dollar.

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[31] 39 B.T.A. 825 (1939) (a case decided under the predecessor to section 902 of the Code).

[32] *But see Commissioner* v. *American Metal Co.*, 221 F.2d 134, 141 (2d Cir.), *cert. denied*, 350 U.S. 879 (1955) (where the foreign corporation kept its books in U.S. dollars, foreign taxes were translated as of their payment date).

[33] The after-tax accumulated profits are included in the denominator (FF300 x $.10/FF = $30).

Section 1248 constructive dividends.—The rules for deemed-paid credits on actual distributions generally applied also to constructive dividends under section 1248 (Treas. reg. sec. 1.1248-1(d)(1)). Under a literal reading of the applicable regulations, however, the amount of the constructive dividend (the numerator of the relevant section 902 fraction) was governed by an earnings and profits computation using the full subpart F method and hence incorporating a currency translation at an average exchange rate.[34] Taxpayers took the position that after-tax accumulated profits (the denominator of the section 902 fraction) and foreign taxes, on the other hand, were translated at the exchange rate in effect on the date of the deemed dividend.[35]

Subpart F constructive dividends.—The full subpart F method was mandated for purposes of computing the taxes deemed paid with respect to constructive distributions under section 951. Thus, exchange gain or loss on current assets and liabilities was reflected in the denominator (earnings and profits) of the section 960 fraction.

Generally, where the U.S. dollar value of a CFC's balance sheet items declined, use of the full subpart F method in the case of a constructive dividend would produce a result more favorable for the taxpayer than that obtainable in the case of an actual distribution. This was because exchange losses that resulted if current assets exceeded current liabilities reduced the denominator of the section 960 fraction. If the CFC elected to repatriate earnings in the form of a section 956 investment (for example, by having a CFC make a loan that extended for more than one year to a U.S. shareholder), no exchange loss reduced the numerator. Thus, by electing to repatriate earnings in the form of a section 956 inclusion, the allowable deemed paid foreign tax credit was increased. The denominator of the section 902 fraction was unaffected by such exchange losses, with the result that exchange losses did not increase the allowable deemed-paid foreign tax credit on actual dividends.

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[34] *But see* D. Ravenscroft, *Taxation and Foreign Currency* 627 (1973) (setting forth an argument that the numerator in the section 902 fraction could be determined under the limited subpart F method, since the full subpart F method of determining earnings and profits is only a limitation on the amount that can be treated as a section 1248 dividend).

[35] *But see* G.C.M. 37133 (May 24, 1977) (concluding that accumulated profits should also be determined under the full subpart F method); G.C.M. 37839 (January 31, 1979) (concluding that foreign taxes should be determined using the full subpart F method for purposes of the section 902 credit—where an election under now repealed section 963 was in effect—and that *Bon Ami* has no application where the full subpart F method is used to compute the U.S. dollar value of the denominator in the section 902 fraction). Although a G.C.M. is not binding as a precedent on the IRS or the courts, a G.C.M. is helpful in interpreting the law in the absence of clear authority.

Reasons for Change

Prior law was unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. Further, no rules were prescribed for determining when the results of a foreign operation could be recorded in a foreign currency, and taxpayers were permitted to use a method of translating foreign currency results into U.S. dollars that was inconsistent with general Federal income tax principles. The result of prior law was uncertainty of tax treatment for many legitimate business transactions, as well as opportunities for tax-motivated transactions. The Congress determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving foreign currency.

Functional currency

The financial accounting concept of functional currency provides a reasonable basis for determining the amount and the timing of recognition of exchange gain or loss.[36] The Act reflects the principle that income or loss should be measured in the currency of a taxpayer's primary economic environment. Under this approach, the U.S. dollar will be the functional currency of most U.S. persons. The Congress recognized, however, that there are circumstances in which it is appropriate to measure the results of a U.S. person's foreign operation in a foreign currency so that a taxpayer is not required to recognize exchange gain or loss on currency that is not repatriated but is used to pay ordinary and necessary expenses.

Foreign currency transactions

The lack of a coherent set of rules for the treatment of foreign currency transactions resulted in uncertainty. The courts addressed several issues by referring to general Federal income tax rules that produced anomalous results when applied to exchange gain or loss (e.g., the treatment of exchange gain on repayment of a loan as income from discharge of indebtedness that is eligible for deferral). Other issues were treated by old cases that were inconsistent with later case law, but that had not been expressly overruled (e.g., whether exchange gain or loss is integrated with gain or loss from an underlying transaction). Further, the IRS and the courts took contrary positions with respect to certain issues (e.g., whether a debtor's exchange gain or loss on repayment of a loan is capital or ordinary in nature).

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[36] There was no uniform system of accounting for foreign currency transactions prescribed by the accounting profession prior to the issuance of Statement of Financial Accounting Standards No. 8 ("FAS 8") by the Financial Accounting Standards Board. FAS 8, which was issued in 1975 effective for fiscal years beginning on or after January 1, 1976, generally required the inclusion of exchange gain or loss in net income for financial reporting purposes. In 1981, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 52 ("FAS 52"), relating to foreign currency translation, for application to foreign currency transactions and financial statements of foreign entities (including branches and subsidiaries). FAS 52 introduced the "functional currency" approach, under which the currency of the economic environment in which a foreign entity operates generally is used as the unit of measure for gains and losses. Under FAS 52, in most cases, exchange gain or loss is treated as an adjustment to shareholders' equity, and not as an adjustment to net income. In defining a "reporting enterprise," FAS 52 distinguishes a "self-contained" operation from an operation that is an integral extension of a U.S. operation; in the latter case, the indicated functional currency is the U.S. dollar.

Multi-currency contracts

Commentators suggested that U.S. tax consequences could be manipulated by arranging to repay a foreign currency denominated loan in U.S. dollars equivalent in value at repayment to the foreign currency borrowed.[37] Foreign lenders and U.S. borrowers utilized a form of debt security under which the lender could dictate the currency in which repayment was to be made. By way of example, it was argued that characterization of an exchange loss on a loan repayment as a capital loss would be avoided if the loan were repaid in U.S dollars, since repayment with U.S. dollars would not involve a sale or exchange. This view ignored the economic reality that the resulting gain or loss would still be attributable to the value of the foreign currency borrowed.[38]

Character of exchange gain or loss

Effect of exchange gain or loss on interest denominated in a foreign currency

Commentators observed that a loan denominated in a foreign currency may reflect a "true" U.S.-dollar interest rate plus an anticipated annual exchange gain or loss.[39] For example, a U.S. taxpayer who borrows a currency that is viewed as strong in relation to the dollar would pay less interest (in nominal terms) than if the taxpayer had borrowed dollars (because the lender expects to be repaid with appreciated currency). Conversely, if the taxpayer borrows currency of a country experiencing high rates of inflation, so that the currency is viewed as weak in relation to the dollar, the taxpayer would pay more annual interest (in nominal terms) than if dollars had been borrowed. In such cases, at least to the extent the parties' expectations prove to be correct, or the parties hedge their positions, it is arguable that nominal interest is understated or overstated, respectively.

The relationship between the dollar price of foreign currency in the forward market and the market interest rate for such currency relative to the dollar supports the view that exchange gain or loss should be treated as interest income or expense. On the other hand, other factors (e.g., a borrower's creditworthiness) affect the stated rate of interest on a foreign currency debt, making it difficult to separate that portion of exchange gain or loss that is equivalent to interest. Even commentators who favor the interest equivalency approach for certain purposes (e.g., characterization) question the result for other Federal income tax purposes (e.g., rules that disallow interest allocable to investments such as tax-exempt bonds). Further, although expectations regarding a currency's future value are material in setting the rate of return on a financial asset or liability, exchange gain or loss could be more or less than expected.

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[37] Committee on Foreign Activities of U.S. Taxpayers, Section of Taxation, American Bar Association, *Report on the U.S. Treasury Department Discussion Draft on Taxing Foreign Exchange Gains and Losses*, 36 Tax L. Rev. 425, 441 (1981). For a contrary view, *see* Newman, *Tax Consequences of Foreign Currency Transactions: A Look at Current Law and an Analysis of the Treasury Department Discussion Draft*, 36 Tax Lawyer 223, 236 (1983).

[38] *See American Air Filter Co.*, 81 T.C. 709 (1983) (where a loan agreement provided that a liability payable in foreign currency could be converted to one payable in another currency, the conversion to a U.S.-dollar liability was treated as a realization event); G.C.M. 39294 (June 15, 1984) (where the IRS noted that repayment in U.S. dollars instead of foreign currency does not alter the tax consequences).

[39] *See, e.g.*, New York State Bar Association's Ad Hoc Committee on Original Issue Discount and Coupon Stripping, *Preliminary Report on Issues to be Addressed in Regulations and Corrective Legislation*, Tax Notes, March 5, 1984, at 993-1034.

Treatment of exchange gain or loss as ordinary income or loss

The Act does not adopt the interest equivalency approach in its entirety, but reflects the position that characterizing exchange gain or loss as ordinary income or loss for most purposes is a pragmatic solution to an issue about which tax scholars and practitioners hold disparate views. The Act authorizes the Secretary to treat exchange gain or loss as interest income or expense in appropriate circumstances (e.g., in the case of hedging transactions where a taxpayer's expectations about future exchange rates are locked in).

It was considered whether unanticipated exchange gain or loss on a financial asset or liability should be characterized as capital gain or loss. This approach was not followed because it is difficult to distinguish anticipated exchange gain or loss from unanticipated exchange gain or loss. Anticipated exchange gain or loss could be measured with reference to the premium or discount element in a forward contract had one been obtained; however, forward contracts are not available in all currencies and do not trade at all maturities. Even where anticipated exchange gain or loss is determinable (e.g., were a taxpayer enters into a forward contract), the Act treats all such gain or loss as ordinary in nature to reduce discontinuities in the law. The elimination of the rate differential between ordinary income and capital gain under the Act reduces the importance of capital gain characterization. A limited exception to this treatment is provided for certain contracts that constitute capital assets in the hands of the taxpayer and are properly identified as speculative investments.

Timing of recognition

Advocates of the interest equivalency approach suggested that a taxpayer's interest income or expense should be adjusted (upwards or downwards) on a current basis, to reflect the "true" borrowing cost or interest income. The current accrual of exchange gain or loss on a borrowing is said to be necessary to properly allocate the additional "interest" to each year the borrowing is outstanding (to match income and expense).

The Congress was not persuaded that exchange gain or loss should be currently accrued in most cases. Because a right to receive (or an obligation to pay) foreign currency is not a right (or obligation) to receive (or pay) a fixed number of dollars, it would be problematical to require income inclusions (or permit deductions) due to exchange gain or loss that could be lost through subsequent exchange rate fluctuations.

The Secretary is authorized to prescribe rules for the current accrual of exchange gain or loss in certain hedging transactions. Further, although it was determined that the Secretary has adequate regulatory authority under the OID and below-market-loan rules to require the proper matching of income and expense on most foreign currency denominated loans (including any extension of credit), the Act grants additional regulatory authority to recharacterize interest and principal payments with respect to obligations denominated in hyperinflationary currencies (where use of the market rate of interest appropriate to the currency might result in a mismatching of income and expense).

Sourcing rules

Exchange gain on a financial asset or liability could be viewed as either foreign source (if ordinary in nature) or domestic source (if treated as capital gain and prior-law section 904(b)(3)(C) applied). The source of a loss on repayment was even less clear. Commentators suggested the following possibilities for allocating exchange losses: (1) exchange loss could be apportioned between domestic and foreign source income in the proportions that these amounts bear to each other in the aggregate, (2) an analogue to the "title passage" rule could apply to allocate losses to foreign source income, or (3) the loss could be allocated by reference to the source of the gain or loss from the underlying transaction.

The Congress determined that the overriding consideration should be to provide certainty regarding the source of exchange gain or loss. The Act accomplishes this result by providing definitive rules that are consistent with the treatment of foreign currency as personal property and the amendments to the sourcing rules in section 1211 of the Act. In general, the Act requires the sourcing of exchange gains and the allocation of exchange losses by reference to the residence of the taxpayer or qualified business unit of the taxpayer on whose books the underlying transaction is properly reflected. For most U.S. taxpayers, this rule will result in the treatment of exchange gain or loss as domestic source or allocable thereto. This result reflects the fact that, in most cases, exchange gains realized by a U.S. taxpayer will not be subject to foreign tax. Moreover, this result will tend to neutralize the effect of exchange gain or loss on the calculation of foreign tax credits (unlike prior law, under which wide swings in exchange rates could result in unpredictable reductions in net foreign source income). Under regulations, exchange gain or loss on certain hedging transactions will be treated in a manner that is consistent with income or expense on the underlying transaction.

Foreign currency translation

The Act utilizes the functional currency approach to distinguish between foreign business operations that are eligible to determine income or loss in a foreign currency (before translation into U.S. dollars) and other foreign operations (the income or loss from which must be measured in dollars, transaction-by-transaction). Under the Act, results recorded in a foreign currency must be translated into U.S. dollars under a profit-and-loss method. The Act also modifies the prior-law rules relating to translation of foreign tax credits.

Adoption of profit-and-loss method

The Congress was concerned about the implicit election enjoyed by CFCs to recognize net exchange losses, and thereby distort the calculation of the deemed-paid foreign tax credit. Account was taken of the argument that the electivity achieved by deciding when to trigger income that would be includible under subpart F could be addressed by requiring an irrevocable election to use a profit and loss method or a net worth method. In considering this option, it was noted that exchange rate fluctuations with respect to certain currencies are predictable with considerable accuracy (e.g., the continuing depreciation of the Brazilian cruzado relative to the U.S. dollar). A taxpayer almost always would elect the net worth method for operations in a country with a weak currency (to accelerate losses) and the profit and loss method for operations in a country with a strong currency (to defer gain). Further, the results achieved under a net worth method are inconsistent with general Federal income tax principles that proscribe the recognition of gains and losses until realized.

A profit and loss method can be viewed as being more consistent with the functional currency concept than a net worth method. Under a profit and loss method, the functional currency is used as the measure of income or loss, so that earnings determined for U.S. tax purposes bear a close relation to taxable income computed by the foreign jurisdiction. Further, a profit and loss method minimizes the accounting procedures that otherwise would be required to make item-by-item translations under a net worth method. Finally, in the case of a branch, the net worth method as applied under prior law failed to characterize accurately items of income or loss that were subject to special U.S. tax rules. For example, although there are limitations on the deductibility of long-term capital losses, such a loss incurred by a branch would be given tax effect because it would be reflected as an adjustment to the balance sheet. Nonetheless, the Act authorizes regulations to prescribe an approximate separate transactions method that does not accelerate the recognition of exchange gain or loss, for application in limited circumstances.

Appropriate exchange rates

The use of a year-end exchange rate distorts income and does not reflect the fact that exchange gain or loss is realized continuously during a taxable year. Accordingly, in most cases, the Act requires the use of a weighted average exchange rate.

Remittances from branches and certain distributions from subsidiaries

In the case of a branch, because the profit and loss method would not translate balance sheet gains and losses, some mechanism for recognizing gains and losses inherent in functional currency or other property remitted to the home office must be provided. A similar issue arises in the case of foreign corporations. Under another provision of the Act, for purposes of the indirect tax credit, the treatment of distributions from foreign corporations as dividends is determined by treating distributions as made from a pool of all of the distributing corporation's earnings and profits. Under the Act, the pooling approach also is used to compute exchange gain or loss on distributions of previously taxed income from CFCs. One of the reasons for the adoption of the pooling approach was to reverse certain prior-law consequences that resulted in the disparate treatment of branch operations and operations conducted through a subsidiary. For the same reason, a pooling approach was adopted for purposes of determining exchange gain or loss on branch remittances.

Foreign tax credits

Under the *Bon Ami* approach, the deemed-paid foreign tax is increased or decreased by exchange rate fluctuations, even if the tax actually was paid in an earlier year (so that the tax liability in terms of U.S. dollars was fixed). This approach is often defended on the ground that it preserves the historic ratio between foreign taxes and accumulated profits, so that the U.S.-dollar value of the foreign tax eligible for credit is the same percentage of the U.S.-dollar value of the dividend as the effective foreign currency denominated tax was of the related earnings. On the other hand, it is not clear that retention of the foreign tax rate should be a goal of U.S. tax policy. The *Bon Ami* approach results in a tax advantage if the foreign corporation's functional currency appreciates against the dollar, and a tax penalty if the functional currency depreciates in value.

Once a subsidiary actually pays a foreign tax, the U.S.-dollar cost is fixed. The *Bon Ami* approach is inconsistent with the rules applied to taxpayers who incur direct foreign taxes (because they operate through branches or incur withholding taxes). This inconsistency defeats one of the purposes of the indirect tax credit, which is to equalize the tax burden on domestic corporations operating abroad through subsidiaries and branches. Further, a corporation operating through a subsidiary always has the option to maintain the desired "historic" relationship between foreign taxes and accumulated profits by repatriating earnings on a current basis. Presumably, this option would be exercised when favorable tax results are anticipated. Thus, it was concluded that foreign taxes should be translated at the historical rate. The Congress was not persuaded that a rule different from that applicable to direct foreign taxes should apply to indirect foreign taxes. Moreover, the Congress believed the purpose of the foreign tax credit would be served more properly by fixing the dollar cost of foreign taxes when those taxes are paid.

Explanation of Provisions

1. Overview

The Act sets forth a comprehensive set of rules for the treatment of foreign currency denominated transactions, in new subpart J. The tax treatment of a foreign currency denominated transaction turns on the identity of the taxpayer's functional currency. Exchange gain or loss is recognized on a transaction-by-transaction basis only in the case of transactions involving certain financial assets or liabilities (referred to as "section 988 transactions") that are denominated in a nonfunctional currency. In the case of section 988 transactions, exchange gain or loss generally is treated as ordinary income or loss. To the extent provided in regulations, exchange gain or loss on certain hedging instruments is characterized and sourced in a manner that is consistent with the related exposure, and a portion of the unrealized exchange gain or loss on section 988 transactions is accrued currently.

A uniform set of criteria is provided for determining the currency in which the results of a foreign operation should be recorded. Business entities using a functional currency other than the U.S. dollar generally are required to use a profit and loss translation method. Exchange gain or loss on a remittance from a branch is treated as ordinary income or loss, and sourced or allocated by reference to the income giving rise to post-1986 accumulated earnings. A consistent set of rules applies to the translation of foreign taxes and adjustments thereto.

2. Functional currency

In general

New section 985(a) generally requires all Federal income tax determinations to be made in a taxpayer's functional currency. The functional currency approach presupposes a long-term commitment to a specific economic environment.

The general rule under the Act requires that taxpayers use the U.S. dollar as the functional currency. Thus, except as otherwise provided, taxpayers must measure income or loss from dealings in foreign currency in U.S. dollars, on a transaction-by-transaction basis. In certain circumstances, described below, a taxpayer is required to use a foreign currency as the functional currency of a "qualified business unit" (generally, a self-contained foreign operation, referred to as a "QBU."). Under these circumstances, income or loss derived from a QBU is determined in a foreign currency (before translation into U.S. dollars). In general, the use of a foreign currency as the functional currency of a QBU will result in the deferral of exchange gain or loss from transactions conducted in that currency.

Business entities

The special rule for QBUs addresses, *inter alia*, the treatment of a case in which a single taxpayer has multiple operations in different economic environments. In such a case, a taxpayer may be eligible to account for the results of a foreign operation by measuring income or loss in the currency of the host country (or, in appropriate circumstances, another foreign country). The application of the rule for QBUs is conditioned on the determination that the foreign operation represents a sufficient commitment to the economic environment of the host country.

In general, the rule for QBUs will apply where a foreign operation constitutes a trade or business, significant activities of which are conducted in the local currency. The Act contemplates that the U.S. dollar will be used as the functional currency of a foreign operation that is an integral extension of a U.S. operation (e.g., a foreign corporation whose sole function is to act as a financing vehicle for affiliated U.S. corporations, or a foreign corporation used to hold portfolio stock investments or similar passive assets that could readily be carried on the parent corporation's books), or a foreign operation with a limited duration (e.g., an offshore construction project undertaken by a U.S. taxpayer). The existence of a QBU does not turn solely on the time frame of a foreign activity, however. For example, in appropriate circumstances (e.g., if the activity is subjected to tax in the host country), an activity of sufficient duration (e.g., 12 months) may support the finding of the existence of a QBU.

Qualified business units

The functional currency of a QBU is the currency of the economic environment in which a significant part of its business activities are conducted, and in which such unit keeps its books and records (new sec. 985(b)(1)(B)). A single taxpayer can have more than one QBU.

Definition of qualified business unit.—The term "qualified business unit" is defined as any separate and clearly identified unit of a taxpayer's trade or business, if such unit maintains separate books and records (new sec. 989(a)). A QBU must include every operation that forms a part of the process of earning income. In general, the statutory definition is satisfied on the basis of vertical, functional, or geographical divisions of a single trade or business, if the business unit is capable of producing income independently. [40] To have a separate set of books and records, a QBU must maintain at a minimum, a separate set of ledger accounts (i.e., cash receipts, cash disbursements, accounts receivable, and accounts payable) and a general journal or similar book of original entry.

Identification of functional currency.—To identify the functional currency of a QBU, the taxpayer must establish that books and records are maintained in the currency of the economic environment in which a significant part of the unit's activities are conducted. The identification of a functional currency requires a factual determination. In making the required determination, the factors taken into account shall include but not be limited to: (1) the principal currency in which revenues and expenses are generated, (2) the principal currency in which the business unit borrows or lends, and (3) the functional currency of related business units and the extent to which the business unit's operations are integrated with those of related business units (if a business unit is an integral component of a larger operation, the economic environment of the larger operation governs the choice of a functional currency). These factors generally correspond to the current criteria that are used to identify a functional currency for financial accounting purposes.[41]

The functional currency of a QBU is deemed to be the U.S. dollar if the unit's activities are conducted primarily in dollars (new sec. 985(b)(2)). Where appropriate, the Secretary may require that dollar transactions entered into by a QBU with a functional currency other than the dollar be kept in dollars. In appropriate circumstances, a domestic QBU (such as a regulated investment company organized to invest in securities denominated in a specific currency) may have a foreign currency as the functional currency.

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[40] An operation that meets this standard is not automatically treated as a separate trade or business for other purposes of the Internal Revenue Code. For example, geographical separation would not provide a basis for treating a business unit as a trade or business under section 446(d), which section permits a single taxpayer to use different accounting methods for separate trades or businesses. Thus, apart from the adoption of a foreign currency as the functional currency of a QBU—which is itself a method of accounting—a taxpayer may be required to use consistent accounting methods for its foreign operations (e.g., cash versus accrual accounting).

[41] *See* Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation," issued by the Financial Accounting Standards Board (December 7, 1981).

It is intended that taxpayers use consistent criteria for identifying the functional currency of qualified business units engaged in similar activities in different countries. If the facts and circumstances do not indicate a particular currency (e.g., where an entity conducts significant business in more than one currency but not primarily in dollars), a taxpayer has discretion in choosing a functional currency. The choice of a functional currency, including an election to use the U.S. dollar (described below), is treated as a method of accounting that can be changed only with the consent of the Secretary (and pursuant to such conditions as the Secretary may prescribe). The Secretary shall address in regulations the appropriate treatment of a taxpayer whose functional currency changes.

The examples below illustrate the identification of a functional currency on the basis of the criteria described above.

Example (1).—A U.S. parent corporation, P, has a wholly owned U.S. subsidiary, S, whose head office is in the United States, although its primary activity is extracting natural gas and oil through a branch in a foreign country. Sales of natural gas and oil are billed in both U.S. dollars and local currency, and significant liabilities and expenses (e.g., loan principal and interest) are denominated in both dollars and local currency. The foreign country requires the branch to keep its books and records in the local currency. In filing federally mandated financial statements P and S elect to use the dollar, not the local currency.

Absent other factors pointing to the predominance of the dollar (such as a high volume of intercompany activities with dollar-based affiliates or a U.S. sales market), the facts do not clearly require the specification of a particular currency. In such a case, the taxpayer would have discretion in choosing between the dollar and the local currency, provided the taxpayer maintains books in the specified currency as described above.

Example (2).—A bank incorporated and with its head office in the United States has a branch in a foreign country. Although the foreign country requires the branch to keep books in the local currency, the branch customarily fixes the terms of its loans to local customers by reference to a contemporary London Inter-Bank Offered Rate (LIBOR) on dollar deposits (e.g., the interest rate on outstanding loan principal equals LIBOR plus two percent and outstanding loan principal is adjusted to reflect changes in the dollar value of the local currency). Local lending is, in turn, typically funded with dollar-denominated funds borrowed from the head office, other branches and subsidiaries of the same bank, and independent lenders. In turn, the branch lends dollars. The bank elects to use the dollar, not the local currency, for Federally mandated financial reporting purposes.

In this instance, although the branch maintains its books and records of operation in foreign currency, the branch's activity is conducted primarily in the U.S. dollar. Under the Act, the branch would be required to use the dollar as its functional currency.

Example (3).—A U.S. taxpayer incorporates a wholly owned subsidiary in Switzerland. All books and records are maintained in Swiss francs, and the Swiss franc is used for financial reporting purposes. The Swiss company is primarily a base company selling the exports of its U.S. parent corporation, and virtually all of its income is foreign base company sales income within the meaning of section 954. Most of its transactions are denominated in U.S. dollars or, less frequently, in foreign currencies other than the Swiss franc.

The U.S. dollar is the functional currency of the Swiss company even though its books and records are maintained in Swiss francs and the Swiss franc is used for financial reporting purposes. This result obtains because the Swiss company's activities are primarily conducted in U.S. dollars.

Election to use U.S. dollar

Apart from the identification of a functional currency under the facts-and-circumstances test (described above), to the extent provided in regulations, a taxpayer can elect to use the U.S. dollar as the functional currency of a QBU. The Secretary is authorized to prescribe regulations permitting the election in two cases: (1) where a QBU maintains its books and records in the U.S. dollar (i.e., uses the separate transactions method), or (2) where a QBU uses a translation method that approximates dollar-based accounting. The Secretary may condition the application of either regulatory exception on the taxpayer making the election for all of the taxpayer's QBUs (on a worldwide basis). The election will be effective for the taxable year for which made and all subsequent taxable years, unless revoked with the consent of the Secretary.

For a U.S. person, the election is to be made on the return for the first taxable year for which a QBU exists, by making a statement that the QBU elects the U.S. dollar as its functional currency for U.S. tax purposes. For a foreign person, the election is to be made in the U.S. owner's return for the first taxable year in which the U.S. owner acquires at least a 50-percent ownership interest in the foreign person by making a statement that the foreign person's QBU elects the U.S. dollar as its functional currency for U.S. tax purposes. For cases in which there is no 50-percent U.S. shareholder, the Secretary is authorized to prescribe regulations providing a mechanism for an election on the occurrence of a significant event (i.e., an event having U.S. tax consequences).

The Secretary's authority to prescribe rules for the election of the U.S. dollar even if books and records are not kept in dollars is limited. This regulatory authority was included to address the concerns of taxpayers operating in hyperinflationary economies. In such a case, local-currency based accounting might not accurately reflect the income or loss of a taxpayer with substantial fixed plant and equipment (because the local currency depreciation charge will become insignificant in relation to operating income). For these taxpayers, an election to use the U.S. dollar as the functional currency will not be conditioned on conforming books and records. There is no expectation that this exception will be made generally available to taxpayers who are not operating in hyperinflationary economies.

The limited exception to the dollar-based books requirement will also require that a QBU use a method of translation that approximates the results of determining exchange gain or loss on a transaction-by-transaction basis. The Secretary may, but is not required to, implement this authority by requiring the comparison of year-end balance sheets using historical exchange rates for *all* balance sheet items. Alternatively, the Secretary may prescribe a modified profit-and-loss method that suffices to address the problem identified in the preceding paragraph.

3. Foreign currency transactions

In general

New section 988 prescribes rules for the treatment of exchange gain or loss from transactions denominated in a currency other than a taxpayer's functional currency. For taxpayers using the U.S. dollar as a functional currency, the Act generally retains the prior law principles under which the disposition of foreign currency results in the recognition of gain or loss, and the Act partially retains the prior law principles under which exchange gain or loss is separately accounted for (apart from any gain or loss attributable to the underlying transaction). As under prior law, the recognition of exchange gain or loss generally requires a closed and completed transaction or realization event (e.g., the actual payment of a liability). The Act introduces a new category of gain or loss, called "foreign currency gain or loss," that will govern the extent to which exchange gains or losses are recognized. The Act modifies prior law regarding the character, source, and—in limited circumstances as provided by regulations—the timing of recognition of exchange gain or loss. Under the Act, foreign currency denominated items are translated into U.S. dollars using the exchange rate that most properly reflects income; generally, the appropriate exchange rate will be the free market rate.

Section 988 transactions

New section 988(c) defines the term "section 988 transaction" to mean certain transactions in which the amount required to be paid or entitled to be received is denominated in a nonfunctional currency, or is determined by reference to the value of one or more nonfunctional currencies. Section 988 transactions are: (1) the acquisition of (or becoming the obligor under) a debt instrument, (2) accruing (or otherwise taking into account) any item of expense or gross income or receipt that is to be paid or received on a later date, (3) entering into or acquiring any forward contract, option, or similar financial instrument (such as a currency swap), unless such instrument is subject to the mark-to-market rule under section 1256, and (4) the disposition of nonfunctional currency.

For purposes of the rule for dispositions of nonfunctional currency, the term nonfunctional currency includes not only coin and currency, but also nonfunctional currency denominated demand or time deposits and similar instruments issued by a bank or other financial institution. Thus, the use of a nonfunctional currency to establish a demand or time deposit denominated in the same nonfunctional currency (or the conversion of such a deposit to another deposit in the same currency) is not a recognition event.

A section 988 transaction need not require or even permit repayment with a nonfunctional currency, as long as the amount paid or received is determined by reference to the value of a nonfunctional currency. (Thus, the status of multi-currency contracts is clarified.) Examples of section 988 transactions are trade receivables or payables, preferred stock (to the extent provided by regulations), and debt instruments denominated in one or more nonfunctional currencies. For purposes of these rules, the term debt instrument means a bond, debenture, note, certificate, or other evidence of indebtedness.

The Secretary is authorized to prescribe regulatory rules that exclude certain transactions from the definition of a section 988 transaction. The Act contemplates that regulations will except any class of items the taking into account of which is not necessary to carry out the purposes of the rules for foreign currency gain or loss derived from section 988 transactions. Examples of items that are within the scope of the Secretary's regulatory authority are trade receivables and payables that have a maturity of 120 days or less, and any other receivable or payable with a maturity of six months or less that would be eligible for exclusion under section 1274 (relating to the determination of issue price of debt issued for nonpublicly traded property). The regulations will prescribe rules for determining the character, source, and timing of exchange gain or loss on excluded transactions.

Treatment of foreign currency gain or loss from section 988 transactions as ordinary income or loss

In general, foreign currency gain or loss attributable to a transaction described in new section 988 is computed separately and treated as ordinary income or loss. Except as otherwise provided by regulations, capital gain or loss treatment may be elected for forward contracts, futures contracts, and options that constitute capital assets in the hands of the taxpayer, are not marked-to-market under section 1256, are not parts of a tax straddle, and that meet certain identification requirements. In circumstances to be identified in Treasury regulations (e.g., certain hedging transactions, described below), foreign currency gain or loss will be treated as interest income or expense.

Foreign currency gain or loss

Foreign currency gain or loss is defined as gain or loss on a 988 transaction, but only to the extent the gain or loss is realized by reason of a change in exchange rates between the date an asset or liability is taken into account for tax purposes (referred to as the "booking date") and the date it is paid or otherwise disposed of, and only to the extent there is gain or loss derived from the transaction as a whole (new sec. 988(b)).[42] Thus, although a taxpayer may have a net gain on a 988 transaction, there is no foreign currency gain if none of the gain is due to changes in the exchange rate between the functional and nonfunctional currencies. On the other hand, if the transaction involves acquisition of an asset denominated in a currency that subsequently appreciates, there is no foreign currency gain if the asset is sold at an overall loss.

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[42] This definition is intended to apply to gain or loss attributable to exchange rate movements affecting the value of forward contracts or similar instruments, regardless of the particular transaction in which the gain or loss is realized.

Example (5).—Assume a taxpayer whose functional currency is the U.S. dollar acquires a pound sterling debt instrument that is not part of a section 988 hedging transaction for 100 pounds when the exchange rate is 1 pound = $1. If the taxpayer sells the obligation for 200 pounds when the exchange rate is 1 pound = $2, $100 of the taxpayer's $300 gain ($400 sales price less $100 basis) is foreign currency gain. This is calculated by multiplying (a) the difference in exchange rates (expressed in dollars per pound) between the booking date and the payment date ($1 per pound) by (b) the original sterling price of the instrument (100 pounds). If the exchange rate at the time of sale were 1 pound = $.5, the taxpayer would have no gain or loss on the 988 transaction and thus no foreign currency gain or loss (because there was no gain or loss derived from the transaction as a whole). If the exchange rate were 1 pound = $.75, the taxpayer would have a $50 gain on the 988 transaction but still no "foreign currency gain" because none of the gain was realized by reason of changes in the exchange rate—rather, the gain was realized *despite* such changes. If the exchange rate were 1 pound = $.25, the taxpayer would have a $50 loss, all of which would be foreign currency loss.

Definition of "booking date".—For transactions involving the acquisition of or becoming the obligor under a debt instrument, the booking date is the date of acquisition or on which the taxpayer becomes the obligor. For transactions involving items of expense or gross income, the booking date is the date on which the item is accrued or otherwise taken into account for Federal income tax purposes. For transactions involving forward contracts or similar investment positions, the booking date is the date on which the position is entered into or acquired.

Definition of payment date.—Generally, foreign currency gain or loss is measured by reference to a holding period that ends on the date on which payment is made or received with respect to a section 988 transaction. For transactions involving forward contracts or similar financial instruments, the Act makes clear that the payment date includes the date on which a taxpayer's rights are terminated with respect to the position (e.g., by entering into an offsetting position).

Calculation of income from discharge of indebtedness.—The Act reverses the result in the *Kentucky & Indiana Terminal Railroad* case.[43] The Act contemplates that gain realized on repayment of a borrowing will be attributed first to foreign currency gain (by calculating the difference between the U.S. dollar value of the loan proceeds when borrowed and when discharged), and only the balance will be treated as income from discharge of indebtedness (sec.

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[43] 330 F.2d 520 (6th Cir. 1964) (exchange gain realized by virtue of repayment of a foreign currency borrowing with depreciated currency characterized as income from discharge of indebtedness).

822 of the Act now prevents anyone but an insolvent taxpayer from deferring income from discharge of indebtedness). This result is just one example of the general rule that, to the extent that gain or loss is derived from a transaction, it is to be attributed first to the effect of movements in exchange rates on the value of the units of nonfunctional currency originally booked by the taxpayer.

Example (6).—Assume a taxpayer whose functional currency is the U.S. dollar borrows 100 pounds sterling, on a note for that amount, when the pound was worth $1. The taxpayer later buys back the note for 80 pounds after the pound has fallen to 50 cents. The gain from the transaction is $60. The change in the U.S. dollar value of the pounds borrowed, measured from the date of issuance to the date of discharge of the note, is $50. Thus, $10 of the gain is discharge of indebtedness income. In any event, if the taxpayer is solvent, the entire amount will be gross income in the year of the discharge.

Calculation of OID.—Although new section 985(a) generally requires a taxpayer to make Federal income tax determinations in its functional currency, the Act contemplates that—pursuant to the Secretary's authority to provide exceptions to this rule—the Treasury Department will issue regulations providing for the determination of OID on an obligation. Pending issuance of regulations, however, OID on an obligation denominated in a nonfunctional currency for any accrual period will be determined in that nonfunctional currency, and translated into the taxpayer's functional currency based on the average exchange rate in effect during the accrual period. The functional currency amount of the OID deducted for any accrual period will be treated as the amount of functional currency added to the borrowing on account of the OID (to determine the adjusted issue price), for purposes of determining the amount of gain or loss realized when the borrowing is repaid. Similar rules are to be prescribed for the calculation of bond premium (sec. 1803(a)(11) of the Act requires taxpayers to use the constant yield method applicable to OID to amortize premium).

Example (7).—On December 31, 1986, the taxpayer, whose functional currency is the U.S. dollar, issues for 85.82 Deutsche marks (DM) a bond that provides for semiannual coupons of 1 DM and a final payment at maturity, on December 31, 1988, of DM100.00 (see table below). The exchange rate on the date of issuance is $0.25/DM, so the amount of the borrowing in the taxpayer's functional currency initially is $21.45. The yield to maturity of the obligation, in terms of DM, is 5 percent, semiannually.

The accrual period is 6 months, commencing with the date of issuance. At the end of the first accrual period, on June 30, 1987, the first 1 DM coupon is paid. Stated interest payments are translated at the exchange rate in effect on the payment date. If the DM appreciates to $0.35 at the end of the first accrual period, the dollar amount of stated interest is $0.35 (1 DM times $0.35/DM). Accrued OID is DM3.29 (5 percent of DM85.82, less stated interest of 1 DM). This amount is translated into dollars using the average exchange rate during the accrual period. If the average value of the DM during the first accrual period is $0.30, then the dollar amount of OID accrued on June 30, 1987, is $0.99 (DM3.29 times $0.30/DM). The taxpayer deducts the dollar amount of accrued OID (in addition to interest paid translated at the payment date) and increases its dollar basis in the bond by the same amount (from $21.45 to $22.44).

As a result of the appreciation of the DM, the taxpayer has an unrecognized currency loss of $8.75, the difference between the dollar basis of the bond, $22.44 and the DM basis translated at the current exchange rate, $31.19 (DM89.11 times $0.35/DM). This currency loss is not recognized until the taxpayer discharges its indebtedness. The currency loss is treated as an ordinary loss, and is allocated by reference to the issuer's residence.

Date Accrual Period Ends	Deutsche Marks (DM)			End of Period Exch. Rate ($/DM)	Avg. Exch. Rate ($/DM)	Dollars ($)			
	Basis	Cash	Accrued OID			Basis	Cash	Accrued OID	Accrued Currency Gain
12/31/86	85.82			.25		21.45			
6/30/87	89.11	1.00	3.29	.35	.30	22.44	.35	.99	−8.75
12/31/87	92.56	1.00	3.45	.40	.37	23.72	.40	1.28	−13.30
6/30/88	96.19	1.00	3.63	.40	.40	25.17	.40	1.45	−13.30
12/31/88	100.00	1.00	3.81	.40	.40	26.70	.40	1.53	−13.30
12/31/88	0	100.00		.40	.40	0	40.00		−13.30
Total		104.00	14.18				41.55	5.25	

Special rule for certain investment products

Except for a transaction that is part of a section 988 hedging transaction and is described in regulations (discussed more fully below), new section 988 does not change the treatment of bank forward contracts or regulated futures contracts that are marked to market under section 1256. The Act provides a special rule for certain financial instruments that are not marked-to-market (e.g., because they are traded on a foreign board or exchange) but are held for speculation: these instruments are accorded capital gain or loss treatment if they constitute capital assets, are not parts of a tax straddle (within the meaning of section 1092(c), without regard to the exception for qualified covered calls in paragraph (4) thereof), and the taxpayer properly identifies them and elects capital treatment. Identification must be made before the close of the day the transaction is entered into (or such earlier time as the Secretary may prescribe by regulations).

Special rule for certain hedging transactions

The Act authorizes the issuance of regulations that address the treatment of transactions that are part of a section 988 hedging transaction. The Congress included this regulatory authority to provide certainty of tax treatment for foreign currency hedging transactions that are fast becoming commonplace (such as fully hedged foreign currency borrowings) and to insure that such a transaction is taxed in accordance with its economic substance. No inference is intended as to the proper treatment of these transactions under prior law. A section 988 hedging transaction includes certain transactions entered into primarily to reduce the risk of (1) foreign currency exchange rate fluctuations with respect to property held or to be held by the taxpayer, or (2) foreign currency fluctuations with respect to borrowings or obligations of the taxpayer. A section 988 hedging transaction is to be identified by the taxpayer or the Secretary.

To the extent provided in regulations, in the case of any transaction giving rise to foreign currency gain or loss that is part of a section 988 hedging transaction (determined without regard to whether any position in the hedge would be marked to market under section 1256), all positions in the hedging transaction are integrated and treated as a single transaction, or otherwise treated consistently (e.g., for purposes of characterizing the nature of income or the sourcing rules). The Congress intends that these regulations address two different categories of hedging transactions.

The first category is a narrow class of fully hedged transactions that are part of an integrated economic package through which the taxpayer (by simultaneously combining a bundle of financial rights and obligations) has assured itself of a cash flow that will not vary with movements in exchange rates. With respect to this category, the Congress intends that such rights and obligations be integrated and treated as a single transaction with respect to that taxpayer. For example, in the case of a fully hedged foreign currency borrowing, a taxpayer with the dollar as its functional currency will borrow foreign currency and hedge its exposure by entering into a series of forward purchase contracts or a single swap agreement.

The forward contracts or swap agreement will assure the taxpayer of a stream of foreign currency flows to make interest and principal payments with respect to the foreign currency borrowing. The taxpayer, although it has borrowed foreign currency, is not at risk with respect to currency fluctuations because it has locked in the dollar cost of its future foreign currency requirements. The Congress intends that regulations treat the entire package as a dollar borrowing with dollar interest payments with respect to the borrower. This integration approach is not limited to U.S. dollar denominated transactions; thus, the rules also apply where several transactions are entered into by a U.S. dollar functional-currency taxpayer to establish a foreign currency position.

In the case of a foreign currency borrowing hedged with a series of forward purchase contracts, the rules of section 1271, *et seq*. and 163(e) shall apply in determining the appropriate interest deduction. The Congress intends that similar rules apply to synthetic dollar securities (e.g., a transaction in which a taxpayer with the dollar as its functional currency purchases a foreign currency denominated debt obligation and sells forward all interest and principal payments to assure itself a stream of fixed dollar flows). The regulations pertaining to integrated hedging transactions will be restricted to transactions that are, in substance, equivalent to a transaction denominated in the taxpayer's functional currency or a nonfunctional currency.

The second category of hedging transactions involves transactions that are not entered into as an integrated financial package but are designed to limit a taxpayer's exposure in a particular currency (e.g., the acquisition of a foreign currency denominated liability to offset exposure with regard to a foreign currency denominated asset). These regulations need not provide for complete integration (e.g., the form of a foreign currency borrowing may be respected and the interest deduction determined by reference to the spot rate on the date of payment). Where appropriate, these regulations should provide for consistent treatment with respect to character, source, and timing.

The Congress intends that both sets of regulations relating to hedging transactions provide rules to prevent taxpayers from selectively identifying only those transactions where the hedging rules are favorable to the taxpayer. Rules applicable to partially hedged transactions may be necessary to achieve a hedging rule that is not susceptible to abuse. The Congress also intends that the regulations require a taxpayer to clearly identify a hedging transaction before the close of the day the transaction is entered into, in order to claim increased deductions attributable to the hedge. The Secretary may identify the transaction as a hedge at a later date. Further, (as discussed below), the Act clarifies the interaction of these rules and the tax straddle provisions, with a view towards providing an incentive for taxpayers to properly identify section 988 transactions that are part of a tax straddle.

In addition, the regulations will need to take account of the various mechanisms for hedging currency exposure. For purposes of the special regulatory rules, a hedging position may include any contract (1) to sell or exchange nonfunctional currency at a future date under terms fixed in the contract, (2) to purchase nonfunctional currency with functional currency at a future date under terms fixed in the contract, (3) to exchange functional currency for a nonfunctional currency at a future date under terms fixed in the contract (which would include parallel loans and currency swaps), or (4) to receive or pay a nonfunctional currency (e.g., cross-currency interest rate swaps).

The Congress particularly is concerned about hedging transactions where a taxpayer borrows in a weak currency and eliminates virtually all risk of currency loss by establishing offsetting currency positions. If such a hedging transaction is not treated as an integrated transaction, the taxpayer may be able to defer tax on income and convert ordinary income to capital gain.

Example (8).—Assume that a taxpayer borrows 1000 units of a weak foreign currency ("F") for 2 years at 30 percent—the market interest rate in this currency. Interest payments are F300 in each of the next 2 years, plus a principal payment of F1000 in 2 years (see table below). The high interest rate charged by lenders of this currency, compared to dollar interest rates, reflects the anticipated devaluation of the foreign currency relative to the dollar.

If the spot market rate for the foreign currency were F2 per dollar, the proceeds from the F1000 loan would be $500 (F1000 divided by F2/$). Suppose the foreign currency can be purchased 1 year ahead in the forward market at F2.3637 per dollar, and 2 years ahead at F2.7934 per dollar. On these facts, the taxpayer could cover its exchange rate exposure on future interest and principal payments by purchasing 1 year ahead F300 for $126.92 (F300 divided by F2.364/$), and 2 years ahead F1300 for $465.38 (F1300 divided by F2.793/$). If the taxpayer fully hedges, then the foreign currency borrowing effectively is converted to a U.S. dollar borrowing of $500 with a repayment schedule (interest and principal) of $126.92 next year and $465.38 in 2 years, resulting in a 10-percent yield to maturity in dollar terms. Under the special rules for integrating certain hedging transactions, this fully hedged foreign currency borrowing would be treated as the equivalent of a U.S. dollar borrowing.

One consequence of treating the hedging transaction described above as a U.S. dollar loan is that the deductibility of interest with respect to the loan is governed by the principles of the OID rules (sec. 1271 *et seq.*). Thus, if the hedging rule were applied, the loan would be treated as a dollar-equivalent loan with a 10-percent yield to maturity, rather than a 30-percent yield, as stated in the contract. Under the hedging rule, only $50.00 (10 percent of the $500 loan balance) of the $126.92 paid at the end of the first year (to cover the F300 of foreign currency liability due in that year) would be characterized as interest expense, and the balance ($76.92) would be characterized as principal (see table below). Thus, in the first year, the effect of integrating the hedging transaction for tax purposes is to reduce the allowable deduction (i.e., interest less any exchange gains, or plus any exchange losses) from $126.92 to $50.00.

Year	Foreign Currency Loan			Forward Market		Dollar-Equivalent Loan		
	Balance (F)	Interest (F)	Principal (F)	Forward rate (F/$)	Cost of Cover ($)	Balance ($)	Interest ($)	Principal ($)
0	1000	0	0	2.0000	0	500.00	0	0
1	1000	300	0	2.3637	126.92	423.08	50.00	76.92
2	0	300	1000	2.7934	465.38	0	42.30	423.08
Sum	NA	600	1000	NA	592.30	NA	92.30	500.00

Over the two-year period, the application of the rules for hedging transactions would not change the net amount of deductions ($92.30) arising from the foreign currency loan; instead, the hedging rule would require that interest be characterized and accrued according to OID principles. In the above example, the effect of the hedging rule is to prevent a one-year deferral of tax on $76.92 of income.

A similar rule would apply in the case of a fully-hedged borrowing in a strong currency (i.e., a currency with an interest rate lower than the dollar interest rate).

Sourcing rules

In general, foreign currency gain is sourced, and foreign currency losses are allocated, by reference to the residence of the taxpayer or qualified business unit on whose books the underlying financial asset or liability is properly reflected.[44] For purposes of these rules, an individual's residence is defined as the country in which the "tax home" (as defined in sec. 911(d)(3)) is located. In the case of any U.S. person (as defined in sec. 7701(a)(30)) other than an individual, the residence is the United States. In the case of a foreign corporation, partnership, trust, or estate, the residence is treated as a foreign country.[45] Where appropriate, foreign currency gain or loss that is treated under the section 988 hedging rules to be prescribed by regulations (discussed above) is to be sourced or allocated in a manner that is consistent with that of the hedged item.

Exception for qualified business units

The residence of a taxpayer's qualified business unit (including the qualified business unit of an individual) is the country in which the unit's principal place of business is located.

Special rule for certain related party loans

The Act provides a special rule for purposes of determining the source or allocation of exchange gain or loss from certain related party loans. This rule was included because of a concern that the general rule that looks to residence could be manipulated to artificially increase foreign source income for purposes of computing allowable foreign tax credits. Under the special rule, affected loans are marked to market on an annual basis, and interest income earned on the loan during the taxable year is treated as domestic source income to the extent of any loss on the loan.

The special rule applies to a loan by a U.S. person or a related person (e.g., a foreign subsidiary) to a 10-percent owned foreign corporation, which loan is (1) denominated in a currency other than the dollar, and (2) bears interest at a rate at least 10 percentage points higher than the AFR for mid-term Federal obligations at the time the loan is made.[46] A 10-percent owned foreign corporation means any foreign corporation in which the taxpayer owns directly or indirectly at least 10 percent of the voting stock. This rule applies only for purposes of subpart J and section 904.

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[44] The rules for sourcing or allocating foreign currency gain or loss apply to investment products with respect to which an election is made to treat gain or loss as capital.

[45] The Act contemplates that the Secretary will address the appropriate treatment of payments made to a counter-party under a swap transaction for purposes of withholding under sections 871 and 881.

[46] The Act provides the Secretary with regulatory authority to apply rules similar to the rules for related-party loans to loans to U.S. persons.

Section 267

Section 267(f)(3)(C) authorizes the Secretary to prescribe regulations excepting certain foreign currency losses from the loss disallowance and loss deferral rules of section 267(a)(1) and section 267(f)(2), respectively. The statutory authorization relates to a loss sustained by a corporate lender on repayment of a foreign currency denominated loan by an affiliated corporation. Pursuant to this regulatory authority, the Secretary has issued temporary regulation sec. 1.267(f)-1T(h).

The Act contemplates that the Secretary will review these temporary regulations with a view towards conforming the regulatory exception to the provisions of the Act. For example, the application of the temporary regulations is limited to a loan that is "payable or denominated solely in a foreign currency;" consistent with the statutory definition of a section 988 transaction, the regulatory rule should take account of a loan where the principal is determined by reference to the value of a nonfunctional currency. Further, the Secretary will determine the appropriateness of applying the 267 regulatory exception to every case currently covered thereunder. In light of the section 989(c)(5) regulatory authority to provide for the appropriate treatment of related-party transactions, for example, the Secretary should determine the extent to which the scope of the section 267 regulatory exception should be limited. Any section 267 exceptions that survive this review should be narrowly drawn.

Application to transactions of a personal nature

Section 988 applies to transactions entered into by an individual only to the extent that expenses attributable to such transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection, or refund of taxes).[47] Thus, for example, section 988 is inapplicable to exchange gain or loss recognized by a U.S. individual resident abroad upon repayment of a foreign currency denominated mortgage on the individual's principal residence. The principles of current law would continue to apply to such transaction.

Tax straddle provisions

The Act coordinates the interaction of the rules for foreign currency gain or loss derived from section 988 transactions and the tax straddle provisions. Neither the loss deferral rule of section 1092 nor the mark-to-market regime under section 1256 will apply to a section 988 transaction that is part of a hedging transaction and described in regulations to be issued under section 988 by the Secretary (although a section 988 hedging transaction could itself constitute a "position" in a tax straddle). Further, as described above, the general rule that treats foreign currency gain or loss as ordinary gain or loss is inapplicable to a section 1256 contract that is marked to market. (The Act requires such gain or loss to be treated as short-term capital gain or loss). In connection with the exception for section 1256 contracts, bank forward contracts with maturities longer than the maturities ordinarily available for regulated futures contracts are within the definition of a foreign currency contract in section 1256(g), if the requirements of that subsection are satisfied otherwise.

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[47] The determination of whether expenses would be deductible under section 212 is made without regard to the two-percent floor (added by sec. 132 of the Act) applicable to investment expenses.

Clarification of application of loss deferral rule

The Act clarifies that an obligor's interest in a foreign currency denominated obligation is a "position" for purposes of the loss deferral rule. The rationale for this treatment is that a foreign currency borrowing is economically equivalent to a short position in the foreign currency. In addition, the Act makes clear that foreign currency for which there is an interbank market is presumed to be "actively traded" property for purposes of the loss deferral rule. No inference is intended regarding the proper application of prior law to a currency that is not the subject of a regulated futures contract but for which there is an active interbank market (e.g., the New Zealand dollar). Thus, the Internal Revenue Service is free to provide by regulations for the treatment of such currencies for taxable years after the effective date of the Economic Recovery Act of 1981 (which introduced the straddle rules) and before the effective date of this Act.

Repeal of special rule for banks

The Act repeals the special rule that permitted banks to qualify for the hedging exception to the straddle provisions without establishing all of the facts that other taxpayers must show.

4. Foreign currency translation

Any entity that uses a nonfunctional currency is required to measure the untranslated results of operation under a profit and loss method, and to translate income or loss into the functional currency at a prescribed ("appropriate") exchange rate for a taxable year. (Thus, the Act repeals the full subpart F method of computing earnings and profits. The Act also supersedes the limited subpart F method permitted under the section 902 regulations.) The Act provides that the translation of payments of, and subsequent adjustments to, foreign taxes by a branch will be performed under the same rules that apply in determining the foreign tax credit allowable to a parent corporation with respect to taxes paid by an affiliated foreign corporation. These translation rules apply without regard to the form of enterprise through which the taxpayer conducts business (e.g., sole proprietorship, partnership, or corporation), as long as the enterprise rises to the level of a QBU.

Application of section 905

For purposes of applying section 905(c), the determination of whether accrued taxes when paid differ from the amounts claimed as credits is made by comparing the U.S. dollar value of the foreign tax accrued to the U.S. dollar value of the amount actually paid. In order to address administrative problems, the Secretary is authorized to prescribe regulations providing for an alternative adjustment (e.g., the adjustment of a dollar-based pool of taxes) in lieu of the redetermination required by section 905(c).

Foreign branches

Translation of taxable income or loss

A taxpayer with a branch whose functional currency is a currency other than the U.S. dollar will be required to use the profit and loss method to compute branch income. Thus, the net worth method will no longer be an acceptable method of computing income or loss of a foreign branch for tax purposes, and only realized exchange gains and losses on branch capital will be reflected in taxable income.

For each taxable year, the taxpayer will compute income or loss separately for each QBU in the business unit's functional currency, converting this amount to U.S. dollars using the weighted average exchange rate for the taxable period over which the income or loss was derived. This amount will be included in income of the taxpayer without reduction for remittances from the branch during the year. Regulations are to provide rules that, in the case of a branch using a functional currency other than the U.S. dollar, will limit the deduction of branch losses to the taxpayer's U.S. dollar basis in the branch (that is, the original U.S. dollar investment plus subsequent capital contributions and advances, indebtedness for which the taxpayer is liable, and unremitted earnings).

A taxpayer will recognize exchange gain or loss on any remittance of property (not just currency, and without regard to whether or when the remittances of currency are converted to dollars), to the extent the value of the currency at the time of the remittance differs from the value when earned. Remittances of foreign branch earnings (and interbranch transfers involving branches with different functional currencies) after 1986 will be treated as paid pro rata out of post-1986 accumulated earnings of the branch. For purposes of calculating exchange gain or loss on remittances, the value of the currency will be determined by translating the currency at the rate in effect on the date of remittance. Exchange gains and losses on such remittances will be sourced or allocated by reference to the income giving rise to post-1986 accumulated earnings (generally, the residence of the QBU, unless the income of the unit is derived from U.S. sources). Regulations may treat contributions of appreciated property to a QBU as a recognition event where appropriate. The rule for triggering exchange gain or loss on remittances is inapplicable to transactions involving the use of a related party's assets or liabilities (e.g., in the case of a bank, the deposit and withdrawal of funds in a branch).

Treatment of direct foreign taxes

The translation of payments (and subsequent adjustments to) foreign taxes paid by a QBU will be performed under the same rules that apply in determining the foreign tax credit allowable to a corporation with respect to taxes paid by an affiliated foreign corporation. [48] Thus, a foreign income tax paid by a QBU is translated into U.S. dollars using the exchange rate in effect as of the time of payment, [49] any refund or credit of a foreign income tax is translated using the exchange rate in effect as of the time of the original payment, and any increase in the amount of a foreign income tax is intended to be translated using the exchange rate in effect when the increase is paid. For example, assume a branch pays a tax of 100 Swiss francs in year one. In year two, the branch's tax liability is 50 francs, and the year one tax is adjusted downwards to 60 francs (so there was an overpayment of 40 francs). In adjusting the liability for year one, the 40-franc overpayment is taken into account at the year one exchange rate. The 40-franc overpayment from year one is credited against the 50-franc liability for year two. In year three, the 50-franc tax for year two is refunded. On these facts, (1) regarding the tax paid in year one, the branch is treated as if a 60-franc tax were paid at the exchange rate in effect when the year-one tax was paid, (2) regarding the crediting of the 40 franc overpayment against the 50-franc tax liability for year two, the entire 50-franc tax is translated at the exchange rate in effect when the year two tax is paid, and (3) on refund of the year-two 50-franc tax in year three, the refund is translated at the same rate that was used to translate the tax credited and paid for year two.

A prepayment of a foreign tax (e.g., payments of estimated taxes or withheld taxes) is to be translated at the same exchange rate in effect on the payment date. A similar rule is to apply to installment payments of tax.

Example (9).—Assume that a domestic corporation organizes a foreign branch in year one. Assume further that the branch is a QBU, and the branch's functional currency is the "K."

	Income	Foreign taxes	Exchange rate
Year 1	100K/$50	23K/$11.50	2K:$1
Year 2	100K/$80	23K/$18.40	1.25K:$1
Year 3	100K/$100	23K/$23	1K:$1

Year one.—Taxpayer has $50 of income, subject to tentative U.S. tax of $17 (calculated at the 34-percent maximum corporate tax rate under the Act), and an offsetting FTC of $11.50. Net U.S. tax is $5.50.

Year two.—Taxpayer has $80 of income, subject to tentative U.S. tax of $27.20, and an offsetting FTC of $18.40. Net U.S. tax is $8.80.

Year three.—Taxpayer has $100 of income, subject to tentative U.S. tax of $34, and an offsetting FTC of $23. Net U.S. tax is $11.

Remittance of after-tax earnings in year three.—Under the Act, the remittance of 231K would trigger $53.90 of exchange gain attributable to the difference between the current exchange rate and the rates in effect for the years in which earned, which is sourced by reference to the source of the related post-1986 accumulated earnings and treated as ordinary income, with no offsetting foreign taxes:

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[48] The Congress intended to apply the same rules to taxpayers who do not operate through QBUs, for purposes of section 901.

[49] The Act did not change the rules that permit taxpayers to calculate foreign tax credits on the basis of foreign taxes accrued but not paid. *See* Section 905. Thus, the Congress did not intend the payment date rule to prevent the allowance of a credit based on accrued foreign taxes where those taxes are unpaid when the credit must be computed.

1. 77K at 2K:$1 =$38.50 (difference of $38.50).
2. 77K at 1.25K$1: =$61.60 (difference of $15.40)
3. 77K at 1K:$1 =$77 (no difference).

Cumulatively, tentative U.S. tax liability is $96.53 (on total income of $230 plus $53.90), the offsetting FTC is $52.90, and the net U.S. tax is $43.63.

Foreign corporations

For purposes of determining the tax of any shareholder of a foreign corporation, the earnings and profits of the foreign corporation are to be determined in the corporation's functional currency. The Act prescribes appropriate exchange rates to translate actual distributions; deemed distributions under subpart F (sec. 1221 of the Act expands the definition of subpart F income), the foreign personal holding company rules, and the new rules (sec. 1235 of the Act) relating to passive foreign investment companies; and gain that is recharacterized under section 1248 as dividend income on the disposition of stock in a CFC or former CFC (sec. 1222 of the Act amends the definition of a CFC). The Act reverses the result under the *Bon Ami* case by requiring the use of an historical exchange rate to translate foreign taxes that are deemed paid. The Act also clarifies the interaction of the foreign currency translation rules and the rules relating to adjustments to foreign taxes.

Translation of earnings and profits

On the actual distribution of earnings and profits from a foreign corporation, a U.S. taxpayer is required to translate such amounts (if necessary) at the current exchange rate on the date the distribution is included in income. Similarly, in the case of gain that is treated as a distribution of earnings under section 1248, the Act requires the deemed dividend to be translated (if necessary) at the current exchange rate on the date the amount is included in income. Thus, for actual distributions and deemed dividends under section 1248, no exchange gain or loss is separately recognized as the result of exchange rate fluctuations between the time earnings and profits arise and the time of distribution.

In the case of deemed distributions under subpart F, the required income inclusion is first calculated in the functional currency and then translated at the weighted average exchange rate for the foreign corporation's taxable year. Exchange gain or loss is recognized as the result of exchange rate fluctuations between the time of a deemed distribution and the time such previously taxed income ("PTI") is actually distributed. The amount of PTI is calculated in the functional currency. Exchange gain or loss on distributions of PTI is to be treated as ordinary income or loss, sourced or allocated in the same manner as the associated income inclusion. The Secretary is authorized to prescribe regulations for the treatment of distributions of PTI through several tiers of foreign corporations.

A weighted average exchange rate is also used to translate foreign personal holding company income and passive foreign investment company ("PFIC") income. The rules for recognizing exchange gain or loss with respect to PTI also apply to previously taxed PFIC income (defined in sec. 1293(c)).

Treatment of deemed-paid foreign taxes

The rules discussed above for translation of direct foreign tax payments by branches are equally applicable for purpose of determining the amount of foreign taxes deemed paid under sections 902 or 960. Thus, a foreign income tax paid by a foreign corporation is translated into U.S. dollars (if necessary) using the exchange rate as of the time of payment. Any refund or credit of a foreign tax is translated using the rate in effect as of the original payment date, and any increase is translated at the rate in effect on the date of adjustment.

Contiguous country corporations

Under section 1504(d), a domestic corporation can elect to treat certain wholly owned subsidiaries organized under the laws of a contiguous foreign country (i.e., Canada or Mexico) as domestic corporations. As a result of treatment as domestic corporations, these subsidiaries are included with the domestic parent corporation in the filing of a consolidated Federal income tax return. The result of a section 1504(d) election combined with use of the net worth accounting method is that gains and losses from contiguous country currency fluctuations are recognized on the U.S. tax return.

In many cases, the administrative burdens that an election under section 1504(d) imposes on the taxpayer would not justify continuation of the election after the effective date of the provision prohibiting the use of the net worth method. Domestic corporations with foreign branches can avoid the adverse impact of switching to the profit and loss method by incorporating their branches. On the other hand, the benefit of foreign incorporation for these purposes is unavailable to contiguous country corporations that are treated as domestic corporations under section 1504(d). Consequently, the Act contemplates that the Internal Revenue Service will allow corporations to elect out of section 1504(d) status as a result of the enactment of the provision requiring use of the profit and loss method.

The ability to revoke section 1504(d) elections will diminish the administrative burdens for both taxpayers and the Internal Revenue Service, eliminate the need for changing the ownership structure in these corporations, and place those corporations on an equal footing with foreign branches of U.S. corporations. As under prior law, the revocation of a section 1504(d) election will (1) trigger excess loss accounts, if any, under Treasury regulation section 1.1502-19, (2) implicate the rules for recapture of foreign losses under section 904(f), and (3) be subject to the rules of section 367(a), among other applicable rules. Any procedure adopted by the Service must contain appropriate safeguards to limit recognition of exchange loss upon the revocation of a section 1504(d) election.

A foreign corporation with respect to which a section 1504(d) election is revoked is likely to succeed to earnings and profits accumulated when it was treated as a domestic corporation. If so, section 243(d) will recharacterize distributions by a foreign corporation out of these accumulated earnings as dividends from a domestic corporation taxable under chapter 1 of the Code. Such recharacterization is necessary to make these distributions eligible for the dividends received deduction. The Act contemplates that to the extent section 243(d) applies to a distribution under these circumstances, the distributing corporation is to be treated as a domestic corporation for purposes of determining under section 243(a)(3) whether the distribution is a 100-percent deductible qualifying dividend. Thus, for example, if a foreign corporation makes a distribution out of earnings and profits that were accumulated by a foreign corporation with section 1504(d) status while such corporation was a member of an affiliated group, and the distributing foreign corporation would be a member of the same affiliated group if it were a domestic corporation, then the distribution qualifies for the 100 percent dividends received deduction provided the domestic parent makes a section 243(b) election and that no section 1562 election was in effect during the year the earnings were accumulated. The domestic parent may make the section 243(b) election even though it files a consolidated federal income tax return. The Act contemplates that the regulations relating to section 243(b) will be modified in order to reflect this clarification.

5. Other issues

In general, the Secretary is authorized to issue such regulations as may be necessary to carry out the purposes of the new rules for foreign currency transactions, including regulations (1) setting forth procedures to be followed by taxpayers with QBUs using a net worth method of accounting before enactment of subpart J, to prevent a mismatching or double inclusions or deductions of exchange gain and loss, (2) limiting the recognition of foreign currency loss on remittances from QBUs (to prevent the selective recognition of exchange losses), (3) providing for the recharacterization of interest and principal payments with respect to obligations denominated in hyperinflationary currencies,[50] and (4) providing for the appropriate treatment of related-party transactions (including transactions between QBUs of the same taxpayer), as well as section 905(c) adjustments (as discussed above). The Act contemplates that the Secretary will also issue regulatory rules providing for the treatment of U.S. branches of foreign persons (addressing issues such as the extent to which exchange gain or loss on remittances are treated as effectively connected with a U.S. trade or business).

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[50] The Congress was made aware of tax shelters that are premised on the creation of debt denominated in a hyperinflationary currency. For example, in one transaction, a U.S. partnership entered into an agreement with a Brazilian sociedade civil limitada for the performance of services in Brazil. Payment was to be made in cruzeiros—the currency used by Brazil before introduction of the cruzado—on a deferred basis, beginning seven years *after* the services were performed. The taxpayers involved took the position that the foreign currency account payable could be accrued currently by the U.S. partnership, even though the actual U.S. dollars required seven years hence will be much less than the U.S.-dollar value of the amount accrued. In this transaction, stated interest was 11 percent per annum, which might be adequate for a dollar borrowing but is below market when compared to the analogous AFR for cruzeiros. Thus, it was concluded that the Secretary has adequate authority to treat this transaction in accordance with its economic substance under the rules relating to below market loans (*See* Prop. Treas. reg. sec. 1.7872-11(f)). Nevertheless, the Congress determined that the Secretary should be granted additional regulatory authority to ensure that such transactions are properly characterized under Federal tax laws, apart from whether stated interest is adequate when measured in a foreign currency.

Effective Date

These provisions are effective for taxable years beginning after December 31, 1986. Generally, section 988 transactions entered into in a taxable year beginning before December 31, 1986, and closed in a taxable year beginning after December 31, 1986, are within these provisions.

For purposes of claiming a deemed-paid foreign tax credit under section 902 or 960, the Act only applies to foreign taxes paid or accrued with respect to earnings and profits of a foreign corporation for taxable years beginning after December 31, 1986. For purposes of claiming a direct foreign tax credit under section 901, the Act is effective for refunds or adjustments made after December 31, 1986 with respect to foreign taxes paid or accrued before December 31, 1986.

Consistent with the general effective date, pre-1987 earnings and profits (including PTI) are translated under prior law rules.[51]

Revenue Effects

These provisions are estimated to have a negligible effect on budget receipts.

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[51] *Cf.* sec. 1202 of the Act (pre-1987 earnings and profits are not subject to the new pooling rules applicable for purposes of the deemed-paid credit).

G. Tax Treatment of Possessions (Secs. 1236 and 1271-1277 of the Act and secs. 32, 48, 63, 153, 246, 338, 864, 876, 881, 882, 931-936, 934A, 957, 1402, 1442, 3401, 6091, 7651, 7654, and 7655 of the Code)[1]

Prior Law

Overview

The income tax laws of the United States were in effect in Guam, the Commonwealth of the Northern Mariana Islands ("CNMI"), the U.S. Virgin Islands, and American Samoa as their local income tax systems. These jurisdictions are termed "possessions" of the United States for tax purposes. To transform the Internal Revenue Code of 1954, as amended ("the Code"), into a local tax code, each possession, in effect, substituted its name for the name "United States" where appropriate in the Code. The possessions generally are treated as foreign countries for U.S. tax purposes. Similarly, the United States generally is treated as a foreign country for purposes of possessions taxation. Although this word-substitution system, known as the "mirror system", applied to Guam, the CNMI, the Virgin Islands, and American Samoa, the U.S. tax relationship with each possession was governed by somewhat different rules, as described below.

Guam

Under the Organic Act of 1950, Guam employed the mirror system of taxation. Under Code section 935, an individual resident of the United States or Guam was required to file, with respect to income tax liability to those jurisdictions, only one tax return—with Guam if the taxpayer was a Guamanian resident on the last day of the taxable year, or with the United States if the taxpayer was a U.S. resident on the last day of the year (the "single filing rule"). Withheld and estimated income taxes paid to the jurisdiction in which a return was not filed could be claimed as a credit against tax imposed by the jurisdiction of filing. In addition, with respect to taxation of U.S. and Guamanian citizens and resident individuals (but not corporations), the United States was treated as part of Guam for purposes of Guamanian taxation, and Guam was treated as part of the United States for purposes of U.S. taxation.

A corporation chartered in Guam that received U.S. source income (other than certain passive income) had to file a U.S. return and pay U.S. tax on that income. Under Code section 881(b), a Guamanian corporation was not treated as a foreign corporation for purposes of the 30-percent withholding tax on certain passive income paid to foreign corporations if (1) less than 25 percent in value of its stock was owned by foreign persons, and (2) at least 20 percent of its gross income was derived from sources within Guam.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 645 and 671-677; H.Rep. 99-426, pp. 482-491; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 944 and 971-977; S.Rep. 99-313, pp. 475-485; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 679-682 (Conference Report).

Under U.S. law, Guam was authorized to impose up to a 10-percent surtax on income tax collected under the mirror system and could provide for rebates of mirror system taxes in certain circumstances.

Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, applies to Guam. In effect, a section 936 corporation operating in a possession such as Guam enjoys an exemption from all U.S. tax on the income from certain business activities and qualified investments in that possession. To qualify for this treatment, the section 936 corporation had to meet two conditions: (1) at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year had to be from sources within the possession; and (2) at least 65 percent of its gross income for that period had to be from the active conduct of a trade or business in that possession.

Federal statutes did not permit Federal employers to withhold territorial income taxes. However, under Code section 7654, the United States generally covered over (i.e., transferred) to the treasury of Guam certain tax collected from individuals on Guamanian source income and withholding tax on Federal personnel employed or stationed in Guam. Similarly, Guam covered into the treasury of the United States certain tax collected from individuals on U.S. source income.

Banks organized in Guam were subject to tax on interest on U.S. Government obligations on a net basis.

CNMI

As of January 1, 1985, the CNMI was required to implement the mirror system in substantially the same manner as the mirror system was in effect in Guam. Code references to Guam were deemed to include the CNMI. Thus, the single filing rule for individuals under Code section 935 and the special withholding tax rule for interest and other passive income earned by corporations under section 881(b) also applied to the CNMI. In addition, U.S. law provided that the CNMI by local law could impose additional taxes and permit tax rebates, but only with respect to taxes on local source income.

Virgin Islands

Under the Naval Appropriations Act of 1922, the income tax laws of the United States, as amended, were held to be "likewise in force in the Virgin Islands", except that the proceeds of the income tax are paid into the treasury of the Virgin Islands. The courts interpreted this provision to establish a mirror system of taxation in the Virgin Islands.

Under section 28(a) of the Revised Organic Act of the Virgin Islands, as interpreted by the courts, an "inhabitant" of the Virgin Islands was exempt from U.S. tax as long as the inhabitant paid tax to the Virgin Islands on its worldwide income. The term "inhabitant", for these purposes, had generally been interpreted to include individual residents of the Virgin Islands, corporations organized under the laws of the Virgin Islands, and corporations not organized under the laws of the Virgin Islands if such corporations had contacts with the Virgin Islands sufficient to establish "residence" in the Virgin Islands.

Notwithstanding section 28(a) of the Revised Organic Act, Virgin Islands corporations, which are generally treated as foreign corporations, were liable for the U.S. 30-percent withholding tax on certain payments to foreign corporations. Under Code section 881(b), however, a Virgin Islands corporation was not treated as a foreign corporation for purposes of this tax if (1) less than 25 percent in value of its stock was owned by foreign persons, and (2) at least 20 percent of its income was derived from sources within the Virgin Islands.

Under Code section 934, the Virgin Islands generally was prohibited from reducing or rebating taxes imposed under the mirror system, with the following exceptions: (1) the prohibition did not apply (with respect to taxes on certain income derived from Virgin Islands sources) in the case of a full-year Virgin Islands resident individual; and (2) the prohibition did not apply (with respect to taxes on non-U.S. source income) in the case of a Virgin Islands or U.S. corporation which derived at least 80 percent of its income from Virgin Islands sources and at least 65 percent of its income from a Virgin Islands trade or business. Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, did not apply to investment in the Virgin Islands. Code section 934(b), in conjunction with section 28(a) of the Revised Organic Act, however, provided similar results. Under Code section 934A, the 30-percent withholding tax on certain payments to foreign persons (including U.S. persons), as imposed under the Virgin Islands mirror system, applied to payments to U.S. persons at a reduced 10-percent rate (which could be further reduced by the Virgin Islands).

The Virgin Islands was authorized to impose up to a 10-percent surtax on the mirror system tax. Otherwise, the Virgin Islands did not have the power to impose local taxes on income.

American Samoa

Unlike the possessions described above, U.S. law permits American Samoa to assume autonomy over its own income tax system. In 1963, American Samoa adopted the U.S. Internal Revenue Code as its local income tax. While American Samoa has the power to modify the Code for purposes of American Samoa's territorial tax, this authority has been exercised on only a few occasions, generally to adapt the Code to the needs of American Samoa.

Under section 931, U.S. citizens who received 80 percent or more of their gross income from sources within American Samoa and 50 percent or more of their gross income from the conduct of a trade or business in American Samoa were exempt from U.S. tax on income derived from sources without the United States. In addition, Code section 936 applies to qualifying U.S. corporations doing business in American Samoa.

Withholding on earnings of U.S. employees

The United States had to withhold on payments to U.S. employees working in certain possessions even though the possession rather than the United States was entitled to tax on those payments. At the end of the year, the United States refunded the withheld amounts to the taxpayer, who was then to satisfy his or her liability to the possession.

Reasons for Change

The Internal Revenue Code, with all its complexities, is designed primarily to tax income in the highly developed U.S. economy. The mirror system, which entails imposing the Code in its entirety as local law, may be wholly inappropriate for the island economies of the U.S. possessions. The possessions need the option to devise tax systems that permit them to pursue their own development policies and to exercise greater control over their own economic welfare.

The frequency and extent of revisions to the Code in recent years have highlighted the problems inherent in the mirror systems. For example, in the possessions, a large portion of the revenue was collected from individuals in the lower tax brackets. Typically, the portion of local revenues collected from corporations and higher-income individuals was very small. Thus, revisions to the Code that lower the tax rates on individuals (such as the rate reductions enacted by the Economic Recovery Tax Act of 1981 and those contained in this Act) could have a substantial adverse effect on the possessions. In addition, revenue-neutral legislation that compensates for lowering tax rates by broadening the tax base may well not be revenue neutral in a possession where relatively little tax is collected from corporations or higher-income individuals.

The prior mirror systems were very complex and the possessions often lacked the resources to enforce these mirror systems effectively. Because of the difficulties of enforcement and the ambiguities and inconsistencies inherent in the mirror system, U.S. taxpayers could seek to abuse the mirror systems.

Therefore, to promote fiscal autonomy of the possessions, it was important to permit each possession to develop a tax system that was suited to its own revenue needs and administrative resources. It was also important to coordinate the possessions' tax systems with the U.S. tax system to provide certainty and minimize the potential for abuse.

The deficiencies in the mirror systems of taxation afflicted each possession, though in differing respects. The close economic relationship between Guam and the CNMI gave rise to mirror system problems resulting, in some cases, in harsh consequences for residents of Guam. With respect to the CNMI, the mirror system of taxation went into full force for the first time in 1985. The CNMI had repeatedly voiced its concern that it lacked the resources to administer and enforce the complex mirror system. In addition, American Samoa had difficulty collecting tax from U.S. Government employees because the United States lacked authority to withhold American Samoan tax from wages.

With respect to the Virgin Islands, the interaction of the Internal Revenue Code with the Virgin Islands Revised Organic Act and the mirror system gave rise to numerous areas of ambiguity and problems of interpretation. These technical difficulties made administration of the law problematic, creating a climate of uncertainty for investors, and raising the possibility of unintended tax benefits for some and harsh consequences for others.

In particular, application of the ambiguous "inhabitant" rule of the Revised Organic Act fostered tax avoidance and tax evasion schemes. A recent case left open the possibility that the interaction of V.I. and U.S. tax law exempted from all tax, in both the United States and the Virgin Islands, U.S. source income earned by a U.S. corporation qualifying as a V.I. inhabitant. This case raised "the prospect of the ultimate tax shelter." *Danbury* v. *United States*, 57 AFTR 2d 86-669 (D.V.I. 1986). Congress found no case to be made for the proposition that it wittingly opened "the ultimate tax shelter" for taxpayers who chose to route their investments through the Virgin Islands. The inhabitant rule was designed to coordinate the U.S. and V.I. tax systems. The incoherence of a coordinating system that allowed U.S. income earned by a U.S. person to escape all tax caused Congress to repeal the inhabitant rule for all open years.

In developing this legislation, Congress sought to respect the choice of each insular area. While Congress believed it was appropriate to provide more local autonomy to these possessions, Congress did not intend to allow them to be used as tax havens. Congress believed that it may be appropriate for these possessions to reduce tax on local income in some cases, but Congress included anti-abuse rules to prevent use of these possessions to avoid U.S. tax. The complexity and ambiguity of the prior law rules provoked taxpayers to take return positions that, while plausible under a literal reading, would have resulted in tax avoidance beyond what taxpayers would even ask from Congress. Congress sought to prevent this in the future.

Explanation of Provisions

Overview

The Act eliminates the requirement that there be a mirror system of taxation in Guam and the CNMI, coordinates the tax systems of those possessions and of American Samoa with the U.S. tax system, and reforms the mirror system in the Virgin Islands. The treatment of the Virgin Islands reflects extended discussions between representatives of the Virgin Islands and the Treasury. It differs from the treatment of the other possessions because of the unique history of the relationship between the Virgin Islands and the United States.

Guam, the CNMI, and American Samoa

Guam, the CNMI, and American Samoa generally are granted full authority over their own local income tax systems with respect to income from sources within, or effectively connected with the conduct of a trade or business within, any of these three possessions and with respect to any income received or accrued by any resident of any of these three possessions. This grant of authority is effective, however, only if and so long as an implementing agreement is in effect between the possession at issue and the United States which provides for (1) eliminating double taxation of income by the possession and the United States; (2) establishing rules for the prevention of evasion or avoidance of U.S. tax; (3) the exchange of information between the possession and the United States for purposes of tax administration; and (4) resolving other problems arising in connection with the administration of the tax laws of such possession and the United States. Any implementing agreement is to be executed on behalf of the United States by the Secretary of the Treasury after consultation with the Secretary of the Interior. Thus, as is currently the case with respect to American Samoa, each of these possessions may adopt a mirror system as its local law if desired.

Congress did not intend that any of these insular areas afford any opportunities for tax avoidance. In particular, Congress did not intend that U.S. agreements with these possessions offer tax advantages beyond those, described below, available in the Virgin Islands.

The Act imposes two requirements on these insular areas. First, it provides that the amount of revenue received by Guam, American Samoa, or the Northern Mariana Islands pursuant to its tax laws during the first fiscal year in which the Act generally takes effect (after conclusion of an implementing agreement) and each of the four fiscal years thereafter shall not be less than the revenue (adjusted for inflation) that possession received pursuant to its tax laws for the last fiscal year before implementation of the Act's rules. Second, the Act provides that nothing in any tax law of Guam, American Samoa, or the Northern Marianas may discriminate against any citizen or resident of the United States or of any other possession or any U.S. corporation or any corporation organized in another possession.

If the Secretary of the Treasury, after consultation with the Secretary of the Interior, determines that any of these three possessions has failed to comply with either the revenue maintenance requirement or the nondiscrimination requirement, the Secretary is to notify the Governor of that possession in writing. If the possession does not comply with that requirement within 90 days of notification, the Secretary is to notify Congress of the noncompliance. Thereupon, unless Congress by law provides otherwise, the mirror system of taxation (that is, the provisions of law in effect before the date of enactment of this Act that applied the provisions of the income tax laws of the United States as in effect from time to time to a possession of the United States) shall be reinstated in that possession, and shall be in full force and effect for taxable years beginning after the notification to Congress. If the failure to comply with the revenue maintenance requirement is for a good cause and does not jeopardize the fiscal integrity of the possession, the Secretary may waive that requirement for the period that he determines appropriate. There is to be no waiver of the nondiscrimination requirement.

Under prior law, the tax system of the Mariana Islands depended on the system in force in Guam. The Act provides that the Northern Mariana Islands are free to continue prior law or to choose the tax regime described in the Act without regard to any action that Guam might take.

An individual who is a bona fide resident of Guam, American Samoa, or the CNMI during the entire taxable year is subject to U.S. taxation in the same manner as a U.S. resident. However, in the case of such an individual, gross income for U.S. tax purposes does not include income derived from sources within any of the three possessions, or income effectively connected with the conduct of a trade or business by that individual within any of the three possessions. Deductions (other than personal exemptions) and credits properly allocated and apportioned to such excluded income will not be allowed for U.S. tax purposes. Thus, even a bona fide resident of Guam, the CNMI, or American Samoa is required to file a U.S. return and to pay taxes on a net basis if he receives income from sources outside the three possessions (i.e., U.S. or foreign source income). However, a U.S. return is not required to be filed if the possession resident's non-possession source income is less than the amount that gives rise to a filing requirement under generally applicable U.S. rules. The United States will cover over to the treasuries of Guam, American Samoa, or the CNMI all U.S. income tax paid by a bona fide Guamanian, Samoan, or CNMI resident. It is anticipated that the possessions will identify these residents to the IRS in the manner done by the Virgin Islands. Congress did not intend that the insular areas grant any taxpayer a tax rebate or other benefit based upon those or any other covered-over taxes that are attributable to non-possessions income.

Amounts paid to a bona fide resident of Guam, the CNMI or American Samoa for any services as an employee of the United States (including pensions, annuities, and other deferred amounts received on account of such services) are not treated as possessions source income, so they are fully taxable by the United States. The U.S. tax on these amounts is to be covered over to the treasury of the possession where the recipient resides, thus providing the possession with the same amount of revenue it received under prior law. Withholding on the compensation of U.S. military personnel stationed or resident in Guam, the CNMI, and American Samoa, will be covered over to the Treasuries of Guam, the CNMI, and American Samoa, as appropriate. No change in the current method of covering over these funds to Guam or the CNMI is anticipated so long as the existing mirror system continues in effect.

The Act delegates to the Secretary of the Treasury the authority to prescribe regulations to determine whether income is sourced in, or effectively connected with the conduct of a trade or business in, one of these possessions, and to determine whether an individual is a resident of one of these possessions. Congress anticipated that the Secretary will use this authority to prevent abuse. For example, Congress did not believe that a mainland resident who moves to a possession while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the possession should escape all tax, both in the United States and the possession, on that appreciation. Similarly, Congress did not believe that a resident of a possession who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside, the possession should escape tax on the income from those assets. The Secretary should treat such income as sourced outside the possession where the taxpayer resides (and any covered over taxes attributable to this income should not be rebated to the taxpayer). Similarly, where appropriate, the Secretary may treat an individual as not a bona fide resident of a possession.

The Act provides that the source rules of section 877(c) apply to any U.S. person who becomes a resident of Guam, American Samoa, or the Northern Mariana Islands for the 10-year period beginning when that person became a resident. These source rules treat as U.S. source income (in addition to amounts that the regular Code and regulatory rules treat as U.S. source income) gains from sales of certain assets with a U.S. connection. This provision applies to income earned after 1985 (whether or not an implementing agreement is in effect). This provision makes it clear, for example, that a U.S. person who moves to one of these possessions while holding appreciated stock of a U.S. corporation and who sells the stock during 1986 cannot contend that the income from that sale is non-U.S. source income the tax on which a possession is free to reduce or rebate. The Act grants regulatory authority to provide exceptions to this rule in cases where the Secretary determines that adequate tax will be collected. Congress did not intend that any regulatory exception contain a subjective standard considering a taxpayer's intent. Since this provision is not in the Code, it is not to be mirrored.

The Act also provides rules which relieve a bona fide resident of Guam, the CNMI or American Samoa from being considered a U.S. person for purposes of applying certain reporting and taxation rules under subpart F with respect to corporations incorporated in Guam, the CNMI, or American Samoa. Residents in one of these possessions are eligible for this relief if: (1) at least 80 percent or more of the corporation's gross income for a preceding three-year period was from sources in, or effectively connected with the conduct of a trade or business in, the possession, and (2) at least 50 percent or more of the corporation's gross income for such period was derived from the conduct of an active trade or business in such possession.

Code section 881(b) was modified to provide that a Guamanian, CNMI, or American Samoan corporation will not be exempt from the 30-percent withholding tax unless (1) less than 25 percent in value of the corporation's stock is beneficially owned by foreign persons; (2) at least 65 percent of the corporation's income is effectively connected with the conduct of a trade or business in a U.S. possession or in the United States; and (3) no substantial part of the income of the corporation is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of one of these three possessions, the Virgin Islands, or the United States. This exception from withholding also applies with respect to corporations organized in the U.S. Virgin Islands.

Local taxes of Guam, the CNMI, and American Samoa will be creditable for U.S. tax purposes if such taxes qualify as creditable taxes under the applicable foreign tax credit regulations.

The Act repeals the rule that subjects Guamanian banks to net basis taxation of interest on U.S. Government obligations (Act sec.

1236). Thus, any Guamanian bank will be exempt from U.S. tax on this income, unless it becomes subject to the anti-conduit rules that apply to Guamanian corporations.

Virgin Islands

An individual qualifying as a bona fide Virgin Islands resident as of the last day of the taxable year will pay tax to the Virgin Islands under the mirror system on his or her worldwide income. He or she will have no final tax liability for such year to the United States, as long as he or she reports all income from all sources and identifies the source of each item of income, expense, and credit on the return filed with the Virgin Islands. Any taxes withheld and deposited in the United States from payments to such an individual, and any estimated tax payments properly made by such an individual to the United States, will be covered over to the Virgin Islands Treasury, and will be credited against the individual's Virgin Islands tax liability. A Virgin Islands resident deriving gross income from sources outside the Virgin Islands will report all items of such income and associated expenses on his or her Virgin Islands return. Information contained on these returns will be compiled by the Virgin Islands Bureau of Internal Revenue and transmitted to the Internal Revenue Service to facilitate enforcement assistance.

Under the Act, for purposes of determining the tax liability of individuals who are citizens or residents of the United States or the U.S. Virgin Islands, the United States will be treated as including the Virgin Islands (for purposes of determining U.S. tax liability), and, under the Virgin Islands "mirror" Code, the Virgin Islands will be treated as including the United States (for purposes of determining liability for the Virgin Islands tax). A corporation organized in one jurisdiction, however, will continue to be treated, where relevant, as a foreign corporation for purposes of individual income taxation in the other jurisdiction.

A citizen or resident of the United States (other than a bona fide Virgin Islands resident) deriving income from the Virgin Islands will not be liable to the Virgin Islands for any tax determined under the Virgin Islands "mirror Code". Rather, in the case of such a person, tax liability to the Virgin Islands will be a fraction of the individual's U.S. tax liability, based on the ratio of adjusted gross income derived from Virgin Islands sources to worldwide adjusted gross income. Such an individual will file identical returns with the United States and the Virgin Islands. The Virgin Islands' portion of the individual's tax liability (if paid) will be credited against his total U.S. tax liability. Taxes paid to the Virgin Islands by the individual, other than the Virgin Islands portion of his U.S. tax liability, will be treated for U.S. tax purposes in the same manner as State and local taxes.

In the case of a joint return where only one spouse qualifies as a resident of the Virgin Islands, resident status of both spouses will be determined by reference to the status of the spouse with the greater adjusted gross income for the taxable year.

The Virgin Islands is provided with authority to enact nondiscriminatory local income taxes (which for U.S. tax purposes would be treated as State or local income taxes) in addition to those imposed under the mirror system.

The Secretary of the Treasury is given authority to provide by regulation the extent to which provisions in the Internal Revenue Code shall not apply for purposes of determining tax liability to the Virgin Islands (i.e., shall not be mirrored). It is anticipated that such regulations will provide that references to possessions of the United States will not be mirrored. In addition, Congress anticipated that these regulations will prevent abuses of the V.I. and U.S. tax systems such as that addressed by section 130 of the Tax Reform Act of 1984 (preventing tax-free payments of U.S. source income to foreign investors which arguably had been possible due to the interaction of the Revised Organic Act and the "mirror Code").

The Act provides that corporations operating in the Virgin Islands are eligible for the possession tax credit allowed under section 936.

The Act provides that the Revised Organic Act is treated as if it were enacted before the Code, so that in cases of conflict, the Code controls. The Act specifies that the Revised Organic Act will have no effect on any person's tax liability to the United States. Thus, for example, even if a U.S. person is treated as an "inhabitant" of the Virgin Islands under the Revised Organic Act, that person will be fully subject to U.S. tax.

The authority of the Virgin Islands to reduce or rebate Virgin Islands tax liability is extended in some cases to income that is not from U.S. sources and that is not effectively connected with the conduct of a trade or business in the United States. As for U.S. persons, however, and corporations 10-percent or more owned (directly or indirectly) by U.S. persons, the Virgin Islands can reduce or rebate tax only on income from V.I. sources or income effectively connected with a V.I. trade or business, although that right applies without regard to whether the affected taxpayer derives any minimum specified percentage of its income from the Virgin Islands. Moreover, any authority to reduce or rebate taxes is conditioned upon the existence of an agreement between the United States and the Virgin Islands containing safeguards against the evasion or avoidance of United States income tax. Congress anticipated that such an agreement would contain measures coordinating the tax administration functions of the Internal Revenue Service and the Virgin Islands Bureau of Internal Revenue, as well as procedures for exchanging tax information.

In allowing reduction of V.I. tax on non-U.S., non-V.I. income of V.I. corporations with less than 10 percent U.S. ownership, Congress did not intend that other U.S. possessions offer tax advantages to non-U.S. investors beyond those available in the Virgin Islands. The Act does not allow the Virgin Islands to reduce or rebate tax on non-V.I. income of local individuals.

This modification of the Virgin Islands' authority to reduce taxes applies only to non-U.S. source income, and income not effectively connected with the conduct of a U.S. trade or business, as those terms are defined under regulations prescribed by the Secretary for this purpose. Congress anticipated that the Secretary would use this authority to prevent abuse. For example, Congress did not believe that a mainland resident who moves to the Virgin Islands while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the Virgin Islands should escape all tax, both in the United States and the Virgin Islands, on that appreciation. Similarly, Congress did not believe that a resident of the Virgin Islands who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside, the Virgin Islands should escape tax on the income from those assets. The Secretary should treat such income as sourced outside the Virgin Islands. Similarly, where appropriate, the Secretary may treat an individual as not a bona fide resident of the Virgin Islands.

Congress expressed the desire that the Secretary of the Treasury consult as appropriate with officials of the Virgin Islands in formulating regulations for purposes of determining tax liability incurred to the Virgin Islands.

As noted above, the Act amends the exemption from the 30 percent withholding tax that applies under section 881(b) to possessions corporations, including Virgin Islands corporations. Under the Act, a Virgin Islands corporation will be exempt from withholding only if (1) less than 25 percent in value of the corporation's stock is owned by foreign persons; (2) at least 65 percent of the corporation's income is effectively connected with the conduct of a trade or business in a U.S. possession or in the United States, and (3) no substantial part of the income of the corporation is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of one of the possessions or the United States. Thus, the exemption from the withholding tax will not be available for a corporation used as a conduit for payments to persons not resident in the Virgin Islands, the United States, or the other possessions.

Withholding on earnings of U.S. employees

The Act eliminates from the definition of wages subject to withholding for U.S. purposes (under Code sec. 3401) any remuneration paid for services for the United States or any U.S. agency within a U.S. possession to the extent the United States or the agency withholds taxes on that remuneration for the account of the possession pursuant to an agreement with the possession. This provision of the Act allows the United States and its agencies not to withhold for the account of the U.S. government on income the tax on which is due to a possession so long as the payor withholds for the account of the possession.

Effective Dates

Guam, the CNMI, and American Samoa

The grants of authority to Guam and the CNMI, as well as the conforming changes to U.S. law, anti-abuse provisions, and administrative provisions, are effective for taxable years beginning on or after the later of January 1, 1987 or the date an implementing agreement between the United States and the possession is in effect. The mirror codes currently administered by Guam and the

CNMI will continue to operate, *mutatis mutandis*, as their respective local income tax laws, until and except to the extent that each possession takes action to amend its tax laws. In addition, the rules of U.S. law relating to Guam and the CNMI as in effect prior to enactment of the Act (such as the single filing rule of Code sec. 935) generally continue in effect until adoption of an implementing agreement. The anti-abuse and administrative provisions with respect to American Samoa also are effective for taxable years beginning on or after the later of January 1, 1987, or the date an implementing agreement between the United States and the possession is in effect. The amendment to the rule taxing Guamanian banks on a net basis on income from U.S. Government obligations is effective for taxable years beginning after November 16, 1985.

Virgin Islands

The Virgin Islands provisions are generally effective for taxable years beginning on or after January 1, 1987. With an exception, described below, the repeal of the Virgin Islands inhabitant rule generally applies to taxable years beginning after 1986. With respect to income other than income from V.I. sources or income that is effectively connected with a V.I. trade or business, it applies (with targeted exceptions) to any income derived in any pre-1987 taxable year for which (on the date of enactment) the assessment of a deficiency of income tax is not barred by any law or rule of law. To the extent that the Virgin Islands either collects tax by the date of enactment or, pursuant to a process in effect before August 16, 1986, collects tax by January 1, 1987, on non-V.I. source, non-V.I. effectively connected income of a V.I. inhabitant that is subject to U.S. tax for pre-1987 taxable years, that V.I. tax is to be creditable against the U.S. tax liability on that income. To the extent that that V.I. tax is imposed on U.S. income, it is to be creditable against U.S. tax on that particular income notwithstanding the general limitations on the foreign tax credit.

In addition, the provisions extending the right of the Virgin Islands to reduce the tax imposed on U.S. or V.I. corporations with respect to income from V.I. sources or income effectively connected with a V.I. trade or business, and the provisions creating the right of the Virgin Islands to reduce the tax imposed on V.I. corporations with respect to income from non-U.S. sources or income effectively connected with a non-U.S. trade or business, will become effective only when an agreement between the United States and the Virgin Islands to cooperate on tax matters becomes effective.

Implementing agreements

If an implementing agreement with any of the four possessions has not been executed within one year from the date of enactment, the Secretary is to report to the tax writing committees, and to the House Committee on Interior and Insular Affairs, in detail the status of negotiations with that possession, and specifically why the agreement has not been executed. Congress intended that the report be forwarded promptly.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $14 million in 1987 and to have a negligible effect on budget receipts thereafter.

TITLE XIII—TAX-EXEMPT BONDS

A. Tax-Exempt Bond Provisions (secs. 1301, 1302, and 1311-1318 of the bill; secs. 25, 103, 103A, and 7871 and new secs. 141-150 of the Code)[1]

Prior Law[2]

Overview

Interest on obligations of States, Territories, and possessions of the United States, and the District of Columbia, generally is exempt from Federal income tax under both prior and present law (Code sec. 103).[3] Similarly, interest on obligations of political subdivisions of these governmental entities generally is tax-exempt.[4]

In determining whether interest on a particular obligation of a qualified governmental unit is tax-exempt, a three-part inquiry is made. First, the authority of the issuer to issue the tax-exempt debt must be established. Second, the activity being financed, and thereby the type of bond being issued, must be determined. (The type of bond generally is determined by the use of the bond proceeds.) Finally, compliance with Internal Revenue Code rules governing tax-exempt bonds for the activity being financed must be established.

Under these rules, qualified governmental units may finance governmental projects or services, including facilities such as schools, roads, and water and sewer facilities. Additionally, under prior and present law, qualified governmental units may provide tax-exempt financing for use by religious, charitable, scientific, or educational organizations (section 501(c)(3) organizations) and for certain activities of other nongovernmental persons (under prior law, by means of certain industrial development bonds (IDBs), student loan bonds, and mortgage revenue bonds). Interest on financings for activities of nongovernmental persons (other than the activities of section 501(c)(3) organizations) was taxable under prior law unless an exception was provided in the Internal Revenue Code for the specific activity being financed.

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[1] For legislative background of the provisions, *see* H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 701-703; H. Rep. 99-426, pp. 492-573; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1501-1516 and 1518; S. Rep. 99-313, pp. 809-861; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 683-762 (Conference Report).

[2] To the extent not changed by the Act, the provisions of prior law are retained. The fact that these provisions may be described in the past tense, in the discussion of Prior Law, is not intended to imply that any rules not so changed by the Act no longer apply to bonds issued under the Internal Revenue Code of 1986.

[3] Governments of States, U.S. possessions and the District of Columbia, and their political subdivisions, are hereinafter referred to collectively as qualified governmental units.

[4] Under a special rule, Indian tribal governments were permitted to issue tax-exempt bonds to finance essential governmental functions of the tribal governments. These governments could not, however, issue IDBs and other conduit-financing bonds.

In certain cases, tax-exempt bonds may be issued on behalf of States or local governments. (*See, e.g.*, Treas. Reg. sec. 1.103-1(b); Rev. Rul. 63-20, 1963-1 C.B. 24; and, Rev. Proc. 82-26, 1982-1 C.B. 476.) References to bonds issued by States or local governments herein generally include bonds issued on behalf of those governmental units under the rules established in these Treasury Department regulations and rulings.

Bonds issued by qualified scholarship funding corporations, and by certain volunteer fire departments, also are treated as obligations of qualified governmental units (secs. 103(e) and 103(i) of prior law).

Bonds for governmental activities

Obligations to finance government operations

Qualified governmental units may issue tax-exempt bonds to finance general government operations and facilities, without regard to most of the restrictions (including volume limitations) that apply to bonds used to finance activities of nongovernmental persons.[5] Under these rules, for example, qualified governmental units may issue notes in anticipation of tax or other revenues (so-called tax anticipation or revenue anticipation notes (TANs or RANs)) to finance cash flow shortfalls.

In addition to issuing bonds as evidence of indebtedness, qualified governmental units may undertake debt, the interest on which is tax-exempt, by means of installment sales contracts or finance leases. For example, a qualified governmental unit may purchase road construction equipment pursuant to a lease purchase agreement or an ordinary written agreement of purchase and sale. Similarly, qualified governmental units may enter into installment purchase or other transactions similar to mortgage loans (*e.g.*, certificates of participation). Interest paid on such acquisitions is tax-exempt if the amounts are true interest (as opposed to other payments labeled as interest). *See, e.g.*, sec. 1273; Rev. Rul. 60-179, 1960-1 C.B. 37; and Rev. Rul. 72-399, 1972-2 C.B. 73. These other types of financings must satisfy the same Code requirements as if a bond actually were issued. Interest paid by qualified governmental units other than pursuant to exercise of their borrowing power (*e.g.*, interest on tax refunds) is not tax-exempt.

Definition of governmental bond

Prior law did not directly define when bond proceeds were used for governmental activities. Rather, bonds were treated as governmental (and the interest thereon was tax-exempt) unless a prescribed amount of the bond proceeds was used for activities of nonexempt persons (*i.e.*, persons other than qualified governmental units or section 501(c)(3) organizations).[6]

Use in trades or businesses

The first case in which bonds issued by qualified governmental units were treated as nongovernmental was when the bonds were IDBs. IDBs were obligations issued as part of an issue (1) all or a major portion of the proceeds[7] of which was to be used (directly or indirectly) in a trade or business carried on by a nonexempt person (the "trade or business use test") and (2) the payment of all or a major portion of the principal of (or interest on) which was to be derived from, or secured by, money or property used in a trade or business (the "security interest test") (sec. 103(b)). The security interest test was satisfied when payments were formally pledged as security for payment of the bonds and also when any underlying arrangement provided for such payments. (*See, e.g.*, Rev. Proc. 83-12, 1983-1 C.B. 674 and Rev. Rul. 85-68, 1985-1 C.B. 37.)

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[5] In general, prior law treated bonds for the benefit of section 501(c)(3) organizations in a manner similar to bonds used to finance governmental operations. While denominated private activity bonds under the Act, these bonds in many respects remain exempt from rules applicable to other private activity bonds.

[6] The United States (including its agencies and instrumentalities) and all persons other than States or local governments (or organizations described in sec. 501(c)(3)), were nonexempt persons under these rules.

Interest on IDBs was taxable unless the bonds were issued to finance certain specified exempt activities, were used for development of industrial parks sites, or were exempt small issues (as described below).

Use to make loans

The second case in which obligations of qualified governmental units were treated as nongovernmental was when the bonds violated a private loan bond restriction.[8] Private loan bonds were defined as obligations that were part of an issue five percent or more of the proceeds of which was reasonably expected to be used, directly or indirectly, to make or finance loans to persons other than exempt persons.

As in the case of IDBs, interest on private loan bonds was taxable unless a specific exception was provided in the Code for the type of loan for which the bond proceeds were to be used. Prior law included exceptions to the private loan bond restriction for activities of nonexempt persons with respect to which Congress had provided specifically in the Code that tax-exempt financing was to be available. Thus, exceptions were provided for IDBs, qualified student loan bonds, qualified mortgage bonds, and qualified veterans' mortgage bonds.[9]

Additionally, an exception was provided for loans to nonexempt persons to finance taxes or assessments of general application for an essential governmental function (tax-assessment bonds). Under this exception, the existence of loans to nonexempt persons was disregarded in determining whether interest on the bonds was tax-exempt. Rather, the determination of whether such interest was tax-exempt was made by determining whether the ultimate use of the bond proceeds qualified the interest on the bonds for tax-exemption. For example, the fact that a qualified governmental unit permitted residents generally to pay mandatory assessments levied in connection with sewer, water, or similar specific governmental projects over a period of years generally was disregarded in determining whether interest on bonds for the water or sewer facilities was tax-exempt. That determination instead was made by reference to the use of the bond-financed property. Thus, if a water or sewer system was owned and operated by a governmental unit, the bonds were governmental bonds, notwithstanding the indirect loans arising from deferred payment of assessments for the system. By contrast, if the system was operated in a manner that caused the bonds to satisfy the trade or business use and security interest tests of the Code, the bonds were IDBs.

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[7] Treasury Department regulations defined a major portion as more than 25 percent of the bond proceeds.

[8] The term private loan bond was substituted for the prior-law term "consumer loan bond" by Title XVIII of the Act, relating to technical corrections to the Deficit Reduction Act of 1984 (the 1984 Act).

[9] Certain private loan bond programs in existence when this restriction was enacted also were not subject to the requirement. (*See*, sec. 626(b) of the 1984 Act.) These programs included certain supplemental student loan bond programs; a veterans' land bond program that had been continuously in effect in substantially the same form for more than 30 years before the enactment of the 1984 Act; and two small-scale energy conservation programs authorized by section 243 of the Crude Oil Windfall Profit Tax Act of 1980.

The private loan bond restriction applied whether bonds were used to finance loans for businesses or to finance personal loans. For example, an issue was an issue of private loan bonds if five percent or more, but no more than 25 percent, of the proceeds were used to make loans that would be considered IDB financing if more than 25 percent of the proceeds were so used. Similarly, a bond could, in some cases, violate the private loan bond restriction although the bonds were not IDBs because the security interest test pertaining to IDBs was not violated (sec. 103(b)(2)(B)).

The concepts of use and loan

Concept of use

General rules.—The use of bond proceeds and of bond-financed property is the basis for determining whether bonds are issued for general government operations or for an activity of a nongovernmental person. Under prior law, the principal application of the use concept was the determination of whether a bond was an IDB. Additionally, the satisfaction of numerous requirements for specific types of tax-exempt IDBs was determined by applying the use concept.

The ultimate beneficiary of the tax-exempt bond financing generally was treated as a user of bond proceeds and of bond-financed property. A person could be a user of bond proceeds or a user of bond-financed property whether the use was direct or indirect. In general, a person was a user of bond proceeds if that person used any bond-financed facility other than as a member of the general public. Thus, a person could be treated as a user of bond proceeds or bond-financed property as a result of (1) ownership of property or (2) actual or beneficial use of property pursuant to a lease, a management contract, or an arrangement such as a take-or-pay or output contract. (*See*, Treas. Reg. sec. 1.103-7(b)(3), (b)(5) and (c).)

Use pursuant to certain management contracts.—Under prior law, the determination of whether use pursuant to a private management contract involved a trade or business use was made on a facts and circumstances basis. The Treasury Department had stated that, under certain specified conditions, it would issue an advance ruling that a facility managed by a private management company was *not* considered to be used in that company's trade or business. Such a ruling generally would be issued only if—

(1) the management services were provided in return for a reasonable, periodic flat fee, under a contract not exceeding 5-years' duration (including renewal options), with the exempt owner having the option to cancel the contract at the end of any 2-year period; or

(2) in the case of certain newly-operational facilities, compensation was based on a percentage of gross revenues from the facility, for a period which generally could not exceed one year.

To qualify under (1) or (2) above, the owner of the facilities and the management company could not be subject to common control, with allowances for *de minimis* cases. (*See*, Rev. Proc. 82-14, 1982-1 C.B. 459.)

Similar principles were applied in determining whether advance rulings would be issued, when bond-financed hospitals or similar facilities were used by nonexempt persons other than employees (*e.g.*, use of public or private, nonprofit charitable hospitals by private physicians). (*See*, Rev. Proc. 82-15, 1982-1 C.B. 460.)

Concept of loan

In addition to the concept of use, the concept of loan was used under prior law to determine whether interest on bonds of qualified governmental units was tax-exempt (*i.e.*, the private loan bond restriction, described above). A loan could result from the direct lending of bond proceeds or could arise from transactions in which indirect benefits that were the economic equivalent of a loan were conveyed. Thus, the determination of whether a loan was made depended on the substance of a transaction, as opposed to its form.

For example, a lease or other contractual arrangement (*e.g.*, a management contract or an output or take-or-pay contract) could in substance constitute a loan even if on its face, such an arrangement did not purport to involve the lending of bond proceeds. A lease or other deferred payment agreement with respect to a bond-financed facility that was not in form a loan generally was not treated as a loan of bond proceeds unless the agreement transferred tax ownership to a nongovernmental person. Similarly, an output or management contract with respect to a bond-financed facility generally was not treated as a loan of bond proceeds unless the agreement in substance shifted significant burdens and benefits of ownership to the purchaser or manager.

The concepts of loan and use were related in that in every case in which a loan was present, the borrower was a user of bond proceeds or bond-financed property. On the other hand, certain limited uses of bond proceeds or bond-financed property did not give rise substantively to a loan.

Exceptions for certain bonds for nongovernmental persons

Industrial development bonds

As indicated above, under prior law, IDBs were obligations issued as part of an issue (1) more than 25 percent of the proceeds of which were to be used in a trade or business carried on by a nonexempt person (*i.e.*, any person other than a governmental unit or a section 501(c)(3) organization), and (2) the payment of more than 25 percent of the principal or interest on which was to be derived from or secured by money or property used in a trade or business. Interest on IDBs was tax-exempt only if the bonds were issued to finance certain specified exempt activities, were used for development of industrial park sites, or were exempt small issues.

Exempt-activity IDBs

One of the exceptions pursuant to which interest on IDBs was tax-exempt was when the proceeds of the bonds were used to finance an exempt activity. Under prior law, the following exempt activities were eligible for tax-exempt financing:

(1) *Airports.*—Tax-exempt IDBs could be issued to finance airports, including related storage or training facilities (sec. 103(b)(4)(D)). Treasury Department regulations provided that airport property eligible for tax-exempt financing included facilities that were directly related and essential to servicing aircraft, enabling aircraft to take off and land, cr transferring passengers or cargo to or from aircraft (*e.g.*, terminals, runways, hangars, loading facilities, repair shops, and radar installations). The regulations further provided that airports included other functionally related and subordinate facilities located at or adjacent to the airport which were of a character and size commensurate with the character and size of the airport in question. For example, Treasury Department regulations provided that a hotel at or adjacent to an airport could be financed with exempt-activity IDBs under prior law if the number of guest rooms was reasonable in relation to the size of the airport (taking into account current and projected passenger usage) and the number and size of meeting rooms (if any) was in reasonable proportion to the number of guest rooms. A maintenance hangar for airplanes similarly was treated as a related structure; however, an office or a computer serving a regional function of an airline company was not functionally related and subordinate property. (*See*, Treas. Reg. sec. 1.103-8(e)(2)(ii).)

In addition to hotels, the Treasury regulations specified that airport facilities eligible for tax-exempt financing included ground transportation, parking areas, and restaurants and retail stores located in terminal buildings. Finally, noise abatement land (*i.e.*, land adjacent to an airport that is impaired by a significant level of airport noise) could be treated as part of an airport under specified circumstances.

(2) *Docks and wharves.*—Exempt-activity IDBs could be used to provide docks, wharves, and related storage and training facilities. Docks and wharves included the structures alongside which vessels dock, equipment needed to discharge cargo and passengers from vessels (*e.g.*, cranes and conveyers), and related storage, handling, office, and passenger areas. (*See*, Treas. Reg. sec. 1.103-8(e)(2)(iii).) Related storage facilities included adjacent grain elevators, warehouses, or oil and gas storage tanks. (*See*, Treas. Reg. sec. 1.103-8(e)(3).)

(3) *Mass commuting facilities.*—Mass commuting facilities eligible for IDB financing included real property, machinery, equipment, and furniture serving bus, subway, rail, ferry, or other commuters on a day-to-day basis, and related storage and training facilities. Mass commuting facilities also included terminals and functionally related and subordinate facilities such as parking garages, car barns, and repair shops. (*See*, Treas. Reg. sec. 1.103-8(e)(2)(iv).)[10]

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[10] Tax-exempt financing for mass commuting vehicles (as opposed to terminals, etc.) previously was authorized as an exempt activity; that authorization expired for bonds issued after 1984.

(4) *Sewage disposal facilities.*

(5) *Solid waste disposal facilities.*

(6) *Facilities for the furnishing of water*, including water furnished for irrigation purposes.

(7) *Facilities for the local furnishing of electric energy or gas*, in areas not exceeding two contiguous counties or a city and one contiguous county.[11]

(8) *Local district heating and cooling facilities.*

(9) *Projects for multifamily residential rental property.*—Tax-exempt IDBs could be issued to finance projects for multifamily residential rental property, if at least 20 percent of the units in the project (15 percent, in targeted areas) were "set aside" for occupancy by low- or moderate-income individuals (sec. 103(b)(4)(A)).[12] The determination of low- or moderate-income was made by reference to rules established under section 8 of the Housing Act of 1937 for determining lower-income families, except that the percentage of family median gross income that qualified as low or moderate was 80 percent (regardless of whether section 8 of the Housing Act of 1937 established another percentage).

Prior-law Treasury Department regulations did not provide specifically that adjustments for family size were to be made in determining the applicable percentage of median gross income to be used under these restrictions. However, the Treasury Department on November 7, 1985, proposed regulations requiring family size adjustments, effective for bonds issued after December 31, 1985 (Prop. Treas. Reg. sec. 1.103-8(b), 50 Fed. Reg. 46303 (Nov. 7, 1985)). Treasury regulations further provided that no unit could be considered to be occupied by low- or moderate-income individuals if all of its occupants were students (as determined under sec. 151(e)(4)), no one of whom was entitled to file a joint income tax return.

The set-aside requirement had to be satisfied continuously during a prescribed "qualified project period" (*i.e.*, 20 percent of the housing units had to continue to be occupied by qualifying low- or moderate-income tenants during this period.) If a tenant qualified as a low- or moderate-income tenant when he or she moved into an apartment, however, that tenant continued to be treated as a low- or moderate-income tenant throughout the period the apartment was occupied, regardless of subsequent increases in the tenant's income. A unit vacated by a low- or moderate-income tenant continued to be treated as occupied by such a tenant until the unit was reoccupied, other than for a temporary period (not exceeding 31 days). In addition to satisfying tenant income requirements, bond-financed multifamily residential rental property was required to remain rental housing throughout the qualified project period.

The term qualified project period was defined as the period beginning on the first date on which at least 10 percent of the units in the project were first occupied (or the date on which the IDBs were issued) and ending on the latest of the date: (1) that was 10 years after the date on which at least 50 percent of the units were first occupied; (2) that was a number of days after the date on which any units were first occupied, equal to one-half of the number of days in the term of the bonds having the longest maturity; or (3) on which any assistance provided to the project under section 8 of the Housing Act of 1937 terminated.

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[11] Under the 1984 Act, two special exceptions were provided treating the Long Island Lighting Company and the Bradley Lake hydroelectric facility in Alaska as satisfying the local furnishing of electricity test (secs. 644 and 645 of the 1984 Act).

[12] Bonds issued under section 11b of the United States Housing Act of 1937 that were in substance IDBs were required to satisfy all Internal Revenue Code requirements applicable to IDBs for multifamily residential rental property, in order to qualify for tax-exemption. This rule applied both to new money and refunding bonds issued after June 18, 1984.

The low- or moderate-income set-aside requirement was reduced from 20 percent to 15 percent in targeted areas. For purposes of this reduced set-aside requirement, the term targeted area was defined as: (1) a census tract in which 70 percent or more of the families had incomes that were 80 percent or less of the applicable statewide median family income, or (2) an area of chronic economic distress as determined under statutory criteria. (*See*, former sec. 103A(k)(3).)

Failure to comply with the set-aside and rental use requirements at any time during the qualified project period resulted in the interest on the bonds becoming taxable, retroactive to the date of issue. Under Treasury Department regulations, however, if noncompliance with the requirements was corrected within a reasonable period (at least 60 days) after the noncompliance reasonably should have been discovered, the tax-exempt status of the bond interest was not affected. (Treas. Reg. sec. 1.103-8(b)(6).)

(10) *Additional exempt activities.*—Prior law also allowed tax-exempt IDB financing for sports facilities; convention or trade show facilities; parking facilities; and air or water pollution control facilities. An exemption for certain hydroelectric generating facilities generally expired after 1985.[13]

Public use requirement for facilities financed by exempt-activity IDBs.—Treasury Department regulations required that to qualify for financing with exempt-activity IDBs, a facility had to serve the general public or be available on a regular basis for general public use, as contrasted with similar types of facilities that were constructed for the exclusive use of a limited number of nonexempt persons in their trades or businesses. For example, the regulations provide that a private dock or wharf serving only a single manufacturing plant would not qualify as a facility for general public use; however, a dock or wharf at a port that served the general public (or a hangar or repair facility at a municipal airport) would qualify even if the specific bond-financed property was owned by, or leased to, a nonexempt person, provided that such nonexempt person directly served the general public (*e.g.*, as a common carrier of passengers and/or cargo). Similarly, an airport owned or operated by a nonexempt person for general public use satisfied the public use requirement; however, a landing strip which, by reason of a formal or informal agreement or by reason of geographic location, would not be available for general public use did not satisfy the requirement. (*See*, Treas. Reg. sec. 1.103-8(a)(2).)

Under the Treasury Department regulations, sewage or solid waste disposal facilities, as well as air or water pollution control facilities, were considered to satisfy the general public use requirement even though they were part of an otherwise nonpublic facility.

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[13] This provision was extended (through 1988) for property with respect to which an application for a license had been docketed by the Federal Energy Regulatory Commission (FERC) before January 1, 1986.

Industrial park IDBs

Under prior law, tax-exempt IDBs could be used to finance the acquisition or development of land as a site for an industrial park.

Small-issue IDBs

In general.—Prior law also permitted tax-exemption for interest on certain small issues of IDBs, the proceeds of which were used for the acquisition, construction, or improvement of land or depreciable property (the "small-issue" exception).[14] Under prior law, the small-issue exception generally was scheduled to expire after December 31, 1986; small-issue IDBs to finance manufacturing facilities could be issued for an additional two years, through 1988.[15]

Small-issue IDBs were issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, could not exceed $10 million.[16] In determining whether an issue met the requirements of the small-issue exception, previous small issues (and in the case of the $10-million limitation, capital expenditures during a six-year period) were taken into account if (1) they were with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with the small-issue IDBs, and (2) the principal users of both facilities were the same, or two or more related, persons.

Capital expenditures were not considered for purposes of the $10-million limit if the expenditures (1) were made to replace property destroyed or damaged by fire, storm, or other casualty; (2) were required by a change in Federal, State, or local law made after the date of issue; (3) were required by circumstances that reasonably could not be foreseen on the date of issue;[17] or (4) were qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

$40-million limitation.—Interest on small-issue IDBs was taxable if the aggregate face amount of all outstanding tax-exempt IDBs (both exempt-activity and small-issue) that would be allocated to any beneficiary of the small-issue IDBs exceeded $40 million. Bonds

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[14] The small-issue exception did not apply to obligations a significant portion of the proceeds of which was to be used to provide multifamily residential rental property. Thus, IDBs to finance residential rental property had to be issued under the exempt-activity IDB exception, discussed above.

[15] Prior law precluded any refunding of small-issue IDBs after the scheduled termination date for originally issuing the type of bond involved.

[16] In the case of facilities with respect to which an Urban Development Action Grant (UDAG grant) had been made (before issuance of the bonds) under the Housing and Community Development Act of 1974, capital expenditures of up to $20 million were allowed.

[17] The excluded expenditures under this exception could not exceed $1 million.

that were to be redeemed with the proceeds of a new issue were not considered.[18]

For purposes of the $40-million limitation, the face amount of any issue was allocated among persons who were owners or principal users of the bond-financed property during a three-year test period.[19] This could result in all or part of a facility being allocated to more than one person, as when one person owned bond-financed property and other persons were principal users, or when owners and/or principal users changed during the three-year test period.[20] Once an allocation to a test-period beneficiary was made, that allocation remained in effect as long as the bonds were outstanding, even if the beneficiary no longer owned or used the bond-financed property.

Mortgage revenue bonds and mortgage credit certificates

Mortgage revenue bonds (MRBs)[21] are bonds issued to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds (former sec. 103A).

Before 1980, no restrictions were placed on issuance of mortgage revenue bonds. The Mortgage Subsidy Bond Tax Act of 1980 limited tax-exemption to two types of MRBs, qualified veterans' mortgage bonds and qualified mortgage bonds.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds were general obligation bonds, the proceeds of which were used to make mortgage loans to veterans. Authority to issue qualified veterans' mortgage bonds was limited to States that had issued such bonds before June 22, 1984, and issuance was subject to State volume limitations based on the volume of issuance by each State before that date. The States eligible to issue these bonds were Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds could be made only with respect to principal residences and could not be made to acquire or replace existing mortgages.

Mortgage loans made with the proceeds of qualified veterans' mortgage bonds could be made only to veterans who served on active duty before 1977, and who applied for the loan before the later of (1) 30 years after the veteran leaves active service, or (2) January 31, 1985.[22]

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[18] Prior law precluded refunding small-issue IDBs if a beneficiary of the IDBs was allocated more than $40 million in tax-exempt IDBs at the time of the refunding (*e.g.*, as a result of bonds issued before enactment of this provision in the 1984 Act). Tax-exemption of interest on bonds issued before the effective date of the 1984 Act was not affected by this provision.

[19] This allocation also was made with respect to bonds issued before enactment of this provision by the 1984 Act, using the 3-year period related to the actual date of issuance of the bonds.

[20] If the $40-million limit was exceeded for any owner or principal user as a result of a change during the test period, interest on the issue of IDBs that caused the limit to be exceeded was taxable from the date of issue. The tax-exempt status of interest on other, previously issued, IDBs was not affected.

[21] The Act retitles mortgage subsidy bonds as mortgage revenue bonds.

[22] Sec. 611(c) of the Deficit Reduction Act of 1984 incorrectly provided that this date was January 1, 1985. Title XVIII of the 1986 Act, relating to technical corrections to the 1984 Act, corrects this reference.

Qualified mortgage bonds

In addition to the rules applicable to all tax-exempt bonds, qualified mortgage bonds were subject to various restrictions. Under prior law, these included a separate set of State volume limitations; borrower eligibility and targeting rules; special arbitrage restrictions; information reporting requirements; and an annual policy statement requirement.

Under prior law, authority to issue qualified mortgage bonds was scheduled to expire after December 31, 1987.

Borrower eligibility requirements.—All lendable proceeds (*i.e.*, total proceeds less costs of issuance and proceeds invested as part of a reasonably required reserve or replacement fund) of qualified mortgage bonds were required to be used to finance the purchase, or qualified improvement or rehabilitation, of single-family residences located within the jurisdiction of the issuing authority. Additionally, it had to be reasonably expected that each residence would become the principal residence of the mortgagor within a reasonable time after the financing was provided. The term single-family residence included two-, three-, and four-family residences if (1) the units in the residence were first occupied at least five years before the mortgage was executed, and (2) one unit in the residence was occupied by the owner of the units.

With certain exceptions, all lendable proceeds of qualified mortgage bonds were required to be used for acquisition of new, rather than existing, mortgages. The exceptions permitted replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Assumptions of loans financed with qualified mortgage bond proceeds were permitted if the assuming mortgagor satisfied the principal residence, first-time homebuyer, and purchase price requirements applicable to qualified mortgage bonds.

Under prior law, in order for an issue to be a qualified mortgage bond issue, at least 90 percent of the lendable proceeds had to be used to finance residences for mortgagors who had no present ownership interest in a principal residence at any time during the three-year period ending on the date the mortgage loan was executed. This first-time homebuyer requirement did not apply with respect to mortgagors in three situations: (1) mortgagors of residences that were located in targeted areas (as described below); (2) mortgagors who received qualified home improvement loans; and (3) mortgagors who received qualified rehabilitation loans.

Under prior law, all mortgage loans provided from the lendable proceeds of a qualified mortgage bond issue (except qualified home improvement loans) were required to be made for the purchase of residences the acquisition cost of which did not exceed 110 percent of the average area purchase price applicable to that residence. This limit was increased to 120 percent of the average area purchase price in targeted areas. The determination of average area purchase price was made separately (1) with respect to new and previously occupied residences, and (2) to the extent provided in regulations, with respect to one-, two-, three-, and four-family residences.

Targeted area requirement.—At least 20 percent of the lendable proceeds of each qualified mortgage bond issue (but not more than 40 percent of the average mortgage activity in the targeted area) was required to be made available for owner-financing in targeted areas for a period of at least one year. The term targeted area was defined as (1) a census tract in which 70 percent or more of the resident families had incomes that were 80 percent or less of the statewide median family income, or (2) an area designated as an area of chronic economic distress using statutorily defined criteria (described in former sec. 103A(k)(3)).

Annual policy statement.—Under prior law, issuers of qualified mortgage bonds and mortgage credit certificates (MCCs) (described below) were required to publish and submit to the Treasury Department an annual report detailing the policies that the jurisdiction intended to follow in the succeeding year with respect to these programs. This report was required to be published and submitted before the last day of the year preceding the year in which any such bonds were issued. A public hearing was required to be held before publication and submission of the report.

Mortgage credit certificate alternative to qualified mortgage bonds

Qualified governmental units could elect to exchange all or any portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitled homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remained in effect as long as the residence being financed continued to be the certificate-recipient's principal residence. MCCs generally were subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC was required to represent a credit for at least 10 percent (but not more than 50 percent) of interest on qualifying mortgage indebtedness. The actual dollar amount of an MCC depended on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeded 20 percent, however, the dollar amount of the credit received by the taxpayer for any year could not exceed $2,000.

Under prior law, the aggregate amount of MCCs distributed by an electing issuer could not exceed 20 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that was authorized to issue $200 million of qualified mortgage bonds, and that elected to exchange $100 million of that bond authority, could distribute an aggregate amount of MCCs equal to $20 million.

When a homebuyer received an MCC, the homebuyer's deduction for interest on the qualifying indebtedness (under sec. 163(a)) was reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making $4,000 of qualifying mortgage interest payments in a given year, would receive a $2,000 credit and a deduction for the remaining $2,000 of interest payments.

Under prior law, authority to elect to issue mortgage credit certificates was scheduled to expire for calendar years after 1987.

Bonds for section 501(c)(3) organizations

Under prior law, religious, charitable, scientific, educational, and similar organizations (described in sec. 501(c)(3)) were treated as exempt persons with respect to the use of bond proceeds. Thus, State and local governments could issue tax-exempt bonds to finance the activities of section 501(c)(3) organizations on a basis similar to that which applied for activities of the governments themselves.[23] The beneficiaries of this type of financing generally were private, nonprofit hospitals and private, nonprofit colleges and universities. This financing was not available with respect to activities of section 501(c)(3) organizations which constituted unrelated trades or businesses.

Student loan bonds

Under prior law, qualified governmental units could issue tax-exempt bonds to finance student loans. Issuance of these bonds was permitted only in connection with loans guaranteed under the Guaranteed Student Loan (GSL) and Parent Loans for Undergraduate Students (PLUS) programs of the United States Department of Education. The GSL and PLUS programs provide three direct Federal Government subsidies for qualified student loans. First, the Department of Education guarantees repayment of qualified student loans. Second, that Department pays special allowance payments (SAPs) as an interest subsidy on qualified student loans, so that the student-borrowers are charged lower interest rates on the loans. Third, the Department pays an additional interest subsidy on qualified loans while the student-borrowers attend school.

Bonds issued by State or local governments in connection with programs other than the GSL or PLUS programs (supplemental student loan bond programs) generally were not tax-exempt under prior law.

Tax-exempt bonds authorized by Federal statutes other than the Internal Revenue Code

Several Federal statutes other than the Internal Revenue Code have authorized issuance of bonds on which the interest is tax-exempt.[24] Examples of these "non-Code" bonds are housing bonds issued under section 11b of the United States Housing Act of 1937 and certain bonds issued by the District of Columbia and United States possessions (Puerto Rico, the Virgin Islands, American Samoa, and Guam). Since January 1, 1984, non-Code bonds have been subject to the same restrictions that apply to Code bonds, the proceeds of which are used for a similar purpose. Further, notwithstanding the provisions of the non-Code statutes authorizing issuance of these bonds, the tax-exemption for all non-Code bonds is treated as derived exclusively from the Internal Revenue Code.

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[23] These bonds were treated as nongovernmental bonds for purposes of the prior-law information reporting requirements (former sec. 103(*l*)).

[24] The 1984 Act provided that, effective after December 31, 1983, new authorizations of tax-exemption may be made only in a revenue Act.

Volume limitations

Under prior law, three separate volume limitations affected the amount of most bonds for nongovernmental persons that each State (including U.S. possessions) could issue during any calendar year. These limitations applied separately to (1) student loan bonds and most IDBs, (2) qualified mortgage bonds, and (3) qualified veterans' mortgage bonds.

Student loan bonds and most IDBs

The annual volume of most IDBs and all student loan bonds that a State, and local issuers therein, could issue under prior law was limited to the greater of (1) $150 for every individual who was a resident of the State[25] or (2) $200 million. The $150-per-capita limitation was to continue through 1986, at which time it was scheduled to be reduced to $100. (The $200-million limitation was to have continued unchanged.) For purposes of the volume limitation, the District of Columbia was treated as a State (and was thus entitled to the $200-million safe harbor limitation); however, U.S. possessions (*e.g.*, Puerto Rico, the Virgin Islands, Guam, and American Samoa) were limited to the $150 per capita amount.

The prior-law State volume limitations did not apply to IDBs the proceeds of which were to be used to finance projects for multifamily residential rental property (former sec. 103(b)(4)(A)). (This exception included public housing program obligations issued under section 11b of the United States Housing Act of 1937.) The volume limitations also did not apply to IDBs the proceeds of which were to be used to finance convention or trade show facilities or airports, docks, wharves, or mass commuting facilities (former sec. 103(b)(4)(C) and (D)), but only if all property to be financed by the IDBs was owned by or on behalf of[26] a governmental unit. This latter exception did not apply to IDB-financed parking facilities (under sec. 103(b)(4)(D) of prior law); however, parking facilities that were functionally related and subordinate to a facility that did qualify under the exception (*e.g.*, airport parking facilities) were included within the exception if the parking facilities satisfied the same governmental ownership requirement as the facility to which they were subordinate.

For purposes of this exception from the volume limitations for certain transportation facilities, IDB-financed property was treated as governmentally owned if no person was entitled to cost recovery deductions or an investment tax credit for any portion of the property. An election to forego cost recovery deductions and investment credit resulted in the property being treated as governmentally owned under this provision even though the property might be considered privately owned using general Federal income tax concepts of ownership. Bond-financed property could qualify for the exception even if the governmental unit's obligation to pay interest and principal on the bonds was limited to revenues from fees collected from users.

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[25] This was to be determined by reference to the most recent estimate of the State's population released by the Bureau of the Census before the beginning of the calendar year to which the limitation applied.

[26] *See*, note 4, *supra*.

For purposes of the volume limitation, student loan bonds included any obligation that was issued as part of an issue all or a major portion of the proceeds of which were to be used directly or indirectly to finance loans to individuals for educational expenses.

The volume limitations did not apply to obligations that were neither IDBs nor student loan bonds (*e.g.*, bonds issued for section 501(c)(3) organizations for use other than in unrelated trades or businesses, and bonds issued to finance general governmental operations), or to bonds that were subject to the separate State volume limitations for qualified mortgage bonds or qualified veterans' mortgage bonds (described below).[27]

Qualified mortgage bonds

Under prior law, the aggregate annual volume of qualified mortgage bonds that a State, and local issuers therein, could issue was limited to the greater of (1) nine percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million. These State volume limitations were separate from, and in addition to, the volume limitations imposed with respect to student loans bonds and most IDBs (discussed above) and qualified veterans' mortgage bonds (discussed below).

Qualified veterans' mortgage bonds

The volume of qualified veterans' mortgage bonds that a qualifying State could issue in any calendar year was limited under prior law to an amount equal to (1) the aggregate amount of such bonds issued by the State during the period beginning on January 1, 1979, and ending on June 22, 1984,[28] divided by (2) the number (not to exceed five) of calendar years after 1979 and before 1985 during which the State actually issued qualified veterans' bonds.[29] For purposes of this limitation, certain obligations having a maturity of one year or less that were used to finance property taxes on residences financed with these bonds were taken into account at 1/15th of their actual principal amount.

Allocation of volume limitations

IDBs, student loan bonds, and qualified mortgage bonds may be issued both by States and by local issuers subject to State law.[30] Prior law permitted each State, by statute, to allocate its volume limitation among the State and local issuers therein in any manner it chose.[31] In the absence of State action, the Code provided that bond authority was to be divided equally between the State, and local issuers therein, with local jurisdictions receiving allocations based on their relative populations (in the case of qualified mortgage bonds, based on relative mortgage activity). Governors were also given authority during an interim period following enactment of each set of limitations to establish rules for allocating bond volume.

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[27] The State of Texas has a program called the Texas Veterans' Land Bond Program under which general obligation bonds are issued for the purchase of land. Loans under this program are limited to $20,000 per veteran. Where the proceeds of such a bond issue, other than an amount that was not a major portion of the proceeds, were used, for example, for the acquisition of land for recreational or other non-trade or -business purposes of its owners, the issue was not subject to this State volume limitation.

[28] This determination was made without regard to bonds issued during the calendar year (or portion thereof) during this period when the lowest volume of such bonds was issued.

[29] This determination was made without regard to any bonds issued by the State after June 22, 1984.

[30] Qualified veterans' mortgage bonds must be general obligation bonds of the issuing State. Thus, these bonds can be issued only by the State itself.

Each person allocating a State's (or local issuer's) volume limitation for IDBs and student loan bonds was required to certify that the allocation was not made in consideration of any bribe, gift, or campaign contribution.

Carryforward of bond authority

In general, each State's annual volume limitation had to be allocated to bonds issued during the calendar year to which the authority related. Under a special election, however, IDB and student loan bond volume authority could be carried forward for up to three years (six years in the case of certain pollution control projects) for a specifically identified exempt-activity IDB project, or for the general purpose of making student loans. Bond authority could not be carried forward for the purpose of issuing small-issue IDBs, qualified mortgage bonds, or qualified veterans' mortgage bonds.

Arbitrage restrictions

General restrictions applicable to all bonds

Permissible arbitrage profits

Interest on any otherwise tax-exempt obligation is taxable if the obligation is an arbitrage bond. Under prior law, an arbitrage bond was defined as an obligation that was part of an issue more than 15 percent of the proceeds of which were reasonably expected to be used (directly or indirectly) to acquire taxable obligations that produced a materially higher yield than the yield on the tax-exempt obligations (or to replace funds that were so used). Exceptions to this general arbitrage restriction were provided for materially higher yielding obligations held for certain temporary periods prescribed in Treasury Department regulations.

Under prior law, the determination of whether bond proceeds were reasonably expected to be invested in materially higher yielding obligations was reasonably expected was made on the date the bonds were issued. The Internal Revenue Service had ruled, however, that subsequent deliberate and intentional acts to produce arbitrage occurring after bonds were issued were not protected by the reasonable expectations test. (*See*, Rev. Rul. 80-91, 1980-1 C.B. 29; Rev. Rul. 80-92, 1980-1 C.B. 31; and Rev. Rul. 80-188, 1980-2 C.B. 47.)

Treasury Department regulations provide rules for determining when an obligation acquired with the proceeds of tax-exempt bonds has a yield materially higher than the bond yield. These regulations apply different arbitrage restrictions to purpose obligations and nonpurpose obligations acquired with the proceeds of tax-exempt bonds. Acquired purpose obligations are obligations acquired to carry out the exempt purpose of the bond issue. All other obligations acquired with bond proceeds are acquired nonpurpose obligations.

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[31] A special rule prevented a State from reducing the bond authority allocation of a constitutional home rule city. In the case of such a city, the Mayor generally was treated as a governor and the city council as a State legislature.

Permissible arbitrage on acquired purpose obligations (other than for bonds issued in connection with certain governmental programs such as student loan bonds) generally is limited, so that the issuer may earn a spread between the yield on the bonds and the yield on the acquired purpose obligations not exceeding 0.125 percentage points plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying, or redeeming the bonds, the underwriter's discount, and the costs of acquiring, carrying, redeeming, or selling the obligation. Permissible arbitrage on acquired nonpurpose obligations is restricted to an amount not exceeding 0.125 percentage points plus certain costs. Additional yield restrictions apply to refundings, overissuances, investments in sinking funds, and other indirect and replacement proceeds of a bond issue.

There are two principal exceptions to the general arbitrage rules. First, unlimited arbitrage is permitted on proceeds invested for a temporary period prior to use, whether held by the issuer or the user of bond proceeds. Under prior law, an issuer was permitted to waive the temporary period and receive an arbitrage spread of 0.5 percentage points (instead of the ordinary 0.125 percentage points) with respect to acquired obligations.

Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund. Under prior law, all amounts held in such a reserve fund were applied against the 15-percent minor portion that could be invested without regard to yield restrictions. Since an issue may not be increased deliberately to take advantage of the minor portion rule,[32] reserve funds were the most important prior-law example of a minor portion on which unlimited arbitrage earnings were permitted.

In the case of student loan bonds and other obligations issued in connection with certain governmental programs, permissible arbitrage on obligations that are acquired in connection with the program (acquired program obligations) generally is limited to a spread between the interest on the bonds and the interest on the acquired program obligations equal to the greater of (1) 1.5 percentage points plus certain reasonable administrative costs, or (2) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). Special allowance payments (SAPs) made by the Department of Education are not taken into account in determining yield on student loan notes. If student loan repayments are placed in a revolving fund, a new temporary period commences when each deposit to the fund is made.

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[32] *See*, Treas. Reg. sec. 1.103-13(j), relating to "artifice or device." Similarly, the maturity of an issue may not be lengthened to exploit the difference between taxable and tax-exempt rates.

Determination of bond yield

The determination of whether bonds are arbitrage bonds depends on a comparison of the yield on the bonds and the yield on the acquired obligations. Under prior law, certain adjustments were permitted that either increased bond yield or decreased the yield on acquired obligations. The case of *State of Washington v. Commissioner*, 692 F.2d 128 (D.C. Cir., 1982), held that bond yield was the discount rate which, when used in computing the present value of all payments of principal and interest on the bonds, produced an amount equal to the net proceeds of the issue after deduction of the costs of issuing the bonds. Because costs were deducted pursuant to the *State of Washington* decision in determining net proceeds, there was a corresponding increase in the bond yield. Therefore, under this case, the bond issuer was permitted a higher yield on the investment of bond proceeds; in effect, the issuer was permitted to pay issuance costs out of arbitrage profits.

Additional arbitrage restrictions on most IDBs

Rebate requirement

IDBs, other than IDBs for multifamily residential rental property, were subject to additional arbitrage restrictions under prior law. Under these additional restrictions, certain arbitrage profits earned on nonpurpose obligations acquired with the gross proceeds of the IDBs were required to be rebated to the Federal Government. No rebate was required if all gross proceeds of an issue were expended within six months of the issue date for the governmental purpose for which the bonds were issued. Additionally, if less than $100,000 was earned on a *bona fide* debt service fund with respect to an issue in a bond year, arbitrage earned on the fund in that year was not subject to the rebate requirement, unless the issuer elected to consider those earnings when determining if a rebate otherwise was due with respect to the issue.

For purposes of these additional IDB restrictions, nonpurpose obligations generally included all investments other than those specifically made to carry out the purpose for which the IDBs were issued. Gross proceeds included the original proceeds of the borrowing, the return on investments of the bond proceeds, and amounts used or available to pay debt service on the bonds. Arbitrage profits required to be rebated included both income earned on investment of the bond proceeds in nonpurpose obligations and all earnings on that income.

Ninety percent of the rebate required with respect to any issue was required to be paid at least once each five years, with the balance being paid within 30 days after retirement of the bonds.

Limitation on investment in nonpurpose obligations

In addition to the rebate requirement, prior-law generally restricted the amount of IDB proceeds that could be invested in nonpurpose obligations at a yield above the bond yield to an amount equal to 150 percent of the debt service. This restriction did not apply to amounts invested for certain temporary periods or to amounts held in a *bona fide* debt service fund. Debt service for this purpose included interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but did not include payments with respect to bonds that were retired before the beginning of the bond year.

Determination of bond yield

For purposes of the additional IDB arbitrage restrictions, the determination of bond yield was made in a manner consistent with the original issue discount rules of the Code (secs. 1273 and 1274). Bond yield thus was determined based on the initial offering price to the public (excluding underwriters, dealers, and brokers). Unlike the rule in *State of Washington v. Commissioner, supra.*, which applied for general arbitrage purposes, this rule did not permit the bond issuer to increase bond yield and thereby recover issuance costs from arbitrage profits.

Additional arbitrage restrictions on qualified mortgage bonds

Additional arbitrage restrictions also were imposed on qualified mortgage bonds under prior law.[33] These restrictions applied both to arbitrage earned on mortgage and on nonmortgage investments.

Mortgage investments

The effective rate of interest on mortgage loans provided with an issue of qualified mortgage bonds could not exceed the yield on the issue by more than 1.125 percentage points. This determination was made on a composite basis for all mortgage loans financed with the proceeds of the issue. Consequently, the effective interest rate on some mortgage loans was permitted to be greater than 1.125 percentage points above the yield of the issue, if other mortgages had a lower effective interest rate.

Nonmortgage investments

As under the prior-law additional arbitrage restrictions for most IDBs, the amount of qualified mortgage bond proceeds that could be invested in nonmortgage investments, at a yield higher than the yield on the issue, was limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt service rule were provided for proceeds invested for an initial temporary period until the proceeds were needed for mortgage loans and for temporary periods related to debt service. Arbitrage earned on nonmortgage investments was required to be paid or credited to the mortgagors or paid to the Federal Government.

Determination of bond yield

Bond yield was determined for purposes of the additional arbitrage restrictions on qualified mortgage bonds using the same method as under the additional restrictions for most IDBs.

Additional arbitrage restrictions on student loan bonds

The 1984 Act directed the Congressional Budget Office and the General Accounting Office to conduct a study of appropriate additional arbitrage restrictions to apply to student loan bonds, and to report to Congress by April 18, 1985.[34] The 1984 Act further directed the Treasury Department to adopt new arbitrage restrictions on these bonds, and specified that restrictions similar to the additional restrictions adopted in that Act for most IDBs could be extended to student loan bonds. Thus, Congress anticipated that earnings on debt service funds could be limited and that rebate requirements could be imposed with respect to nonpurpose obligations. Additionally, the 1984 Act provided that these regulations could eliminate the rule providing special treatment of special allowance payments (SAPs), which was included in the prior-law general arbitrage restrictions, discussed above. These new arbitrage restrictions generally could not apply to bonds issued before six months after their adoption by Treasury.

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[33] Under prior law, qualified veterans' mortgage bonds were not subject to any additional arbitrage restrictions beyond the restrictions imposed on tax-exempt bonds generally.

Advance refundings

In the case of IDBs and mortgage revenue bonds,[35] interest on refunding bonds was tax-exempt under prior law only if the refunding bonds were issued no more than 180 days before the refunded issue was redeemed. Interest on refunding bonds that were outstanding for more than 180 days before the refunded IDBs or mortgage revenue bonds were redeemed (advance refunding bonds) generally did not qualify for tax-exemption. (*See*, Prop. Treas. Reg. sec. 1.103-7(e).) Advance refundings were permitted in the case of bonds the proceeds of which were used for general government operations or by tax-exempt organizations (described in Code sec. 501(c)(3)).

For purposes of these rules, a refunding issue was an issue used to pay principal, interest, or call premium on a prior issue, together with reasonable incidental costs of the refunding. An issue was not treated as a refunding issue for purposes of the restriction on advance refundings if the prior issue was an issue of IDBs with a term of less than three years (including the term of any prior refunded notes) and was sold in anticipation of permanent financing. Thus, these short-term obligations could be refunded more than 180 days before the obligations were redeemed. (*See*, Prop. Treas. Reg. sec. 1.103-7(e).)

Proceeds of a refunding issue (other than an advance refunding) generally were treated as used for the same purposes as the issue being refunded. For example, if the refunded issue were used for an exempt activity under the rules applicable to IDBs, the refunding obligation generally also was considered to be so used.

Additional restrictions on IDBs

Application of IDB proceeds to purpose of borrowing

Under prior law, exempt-activity IDBs could be used to finance an exempt facility, and additionally, any land, building, or other property that was functionally related and subordinate to the exempt facility. (*See*, Treas. Reg. sec. 1.103-8(a)(3).) (Functionally related and subordinate facilities are illustrated in the discussion of exempt-activity IDBs, above.)

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[34] The Congressional Budget Office portion of this study was submitted to Congress in August 1986. The General Accounting Office portion of the study has not yet been submitted to Congress.

[35] This restriction applied both to qualified mortgage bonds and to qualified veterans' mortgage bonds.

Exempt-activity IDBs qualified for tax-exemption if "substantially all" of the bond proceeds were used to finance one or more of the statutorily exempt categories of facilities, including functionally related and subordinate property. Treasury Department regulations provided that the use of 90 percent or more of bond proceeds to provide exempt facilities satisfied the "substantially all" requirement. (*See*, Treas. Reg. sec. 1.103-8(a)(1).) Similar rules applied in the case of small-issue and industrial park IDBs.

Public approval requirement

For interest on IDBs to be tax-exempt, prior law required that a public hearing be held, and that the issuance of the bonds be approved by an elected public official or elected legislative body. As an alternative to these requirements, issuance of the IDBs could be approved by a voter referendum. These restrictions applied to all IDBs, including IDBs exempt from the State volume limitations; however, they did not apply to student loan bonds or to other tax-exempt bonds that were not IDBs.

If the bond-financed property was located outside of the issuing jurisdiction, the public approval requirement generally had to be satisfied by the issuing jurisdiction and all other jurisdictions in which the bond-financed property (or parts thereof) was to be be located. The requirement was satisfied, however, if one governmental unit, having jurisdiction over all the property being financed, held a hearing and approved issuance of the bonds (*e.g.*, a hearing held at the State level followed by the governor's approval of the issue). Additionally, in the case of governmentally owned airports, the requirement could be satisfied by approval by the governmental unit that issued the bonds and owned the bond-financed property.

Restriction on maturity of IDBs

Prior law restricted the weighted average maturity of all IDBs to no more than 120 percent of the economic life of the property to be financed. For example, if the proceeds of an issue of IDBs were used to purchase assets with a weighted average estimated economic life of 10 years, the weighted average maturity for the bonds could not exceed 12 years. The economic life of a facility was measured from the later of the date the bonds were issued or the date the assets were placed in service.

For purposes of this restriction, the economic life of facilities was determined on a case-by-case basis. However, the legislative history of the restriction stated that, in order to provide guidance and certainty, the administrative guidelines used to determine useful lives for depreciation purposes before enactment of the ACRS system (*i.e.*, ADR midpoint lives and the guideline lives under Rev. Proc. 62-21, 1962-2 C.B. 418, in the case of structures) could be used to establish the economic lives of assets.[36]

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[36] *See*, H. Rpt. No. 97-760, 97th Cong., 2d Sess. (August 17, 1982), p. 519.

Restrictions on acquisition of land and existing property

Prior law included two restrictions on the circumstances under which land could be financed with IDBs.

Nonagricultural land

Interest on IDBs was taxable under prior law if more than 25 percent of the proceeds of the issue was used to finance the acquisition of any interest in nonagricultural land. This restriction applied both to exempt-activity and to small-issue IDBs. The 25-percent restriction was increased to 50 percent in the case of IDBs issued to finance an industrial park (described in former sec. 103(b)(5)). An additional exception to the land acquisition limitation was provided for certain land acquired by a public agency in connection with an airport, mass transit, or port development project (described in former sec. 103(b)(4)(D)) for noise abatement, wetland preservation, future use, or other public use, but only if there was no other significant use of the land after its acquisition and before the expansion occurred.

Agricultural land

Agricultural land could be financed with small-issue IDBs if two conditions were satisfied.[37] First, loans for agricultural land had to be limited to first-time farmers, and second, each first-time farmer was limited to a maximum of $250,000 of IDB financing. A first-time farmer was defined as an individual who at no time had any direct or indirect ownership interest in substantial farmland in the operation of which the individual or the individual's spouse or dependent children materially participated. Substantial farmland for this purpose included any parcel of land (1) that was greater than 15 percent of the median size of a farm in the county in which the land was located, or (2) the fair market value of which exceeded $125,000 at any time when the land was held by the individual in question.

Under prior law, a *de minimis* portion of IDB financing provided under the first-time farmer exception could be used for the acquisition of used farming equipment (without regard to the restriction on financing existing property, discussed below). Only equipment acquired within one year after acquisition of the farmland was eligible for tax-exempt financing under this exception.

Under prior law, the authority to issue bonds for first-time farmers was scheduled to expire after December 31, 1986.

Existing property

Tax-exempt IDBs generally could not be used to finance the acquisition of previously used property. As with the restriction on land acquisition, this restriction applied both to exempt-activity and small-issue IDBs. An exception was provided, however, permitting the acquisition of an existing building (and equipment for such a building) if expenditures for rehabilitation of the building and equipment exceeded 15 percent of the amount of bonds issued for acquisition of the building and related equipment. A parallel exception also applied to nonbuilding real property structures (*e.g.*, dry docks), but in such cases, the rehabilitation expenditures were required to exceed 100 percent of the bond financing.

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[37] Agricultural land is eligible for financing only under the small-issue exception.

Qualified rehabilitation expenditures generally included any amount chargeable to capital account that was incurred in connection with the rehabilitation project. Only expenditures incurred before the date that was two years after the later of (i) the date the building was acquired or (ii) the date the bonds were issued, were treated as qualified rehabilitation expenditures. In the case of an integrated operation contained in a building before its acquisition, rehabilitation expenditures also included the expenses of rehabilitating existing equipment previously used to perform the same function in the building, or replacing the existing equipment with equipment having substantially the same function.

Ownership of bond-financed property

Under prior law, qualification for tax-exempt financing generally was determined by reference to the type of activity being financed, rather than the ownership of bond-financed property. Thus, bond-financed property might be owned by (or on behalf of) a governmental unit or, in other cases, by a nongovernmental person, as in the case of bond-financed property for section 501(c)(3) organizations and property financed with IDBs and mortgage revenue bonds.[38]

Governmental ownership of bond-financed property was a condition for excluding IDBs for certain transportation facilities (*e.g.*, airports) from the statewide volume limitations of prior law, as described above. However, economic or tax ownership was not required for purposes of this exception. Rather, property was deemed to be owned by a governmental unit if an election was made by the nongovernmental beneficiary of tax-exempt financing to forego cost recovery deductions and the investment tax credit.

Cost recovery deductions for bond-financed property

The cost of property that is used in a trade or business or otherwise for the production of income, and that has a useful life of more than one year, may be recovered through tax deductions (sec. 168). The prior-law Accelerated Cost Recovery System (ACRS) prescribed recovery periods of from 3 years to 19 years for such property. These recovery periods generally were shorter than the economic life of the property. In addition, the ACRS system prescribed a cost recovery method that accelerated cost recovery by permitting larger deductions in the early years of the recovery period.

Under prior law, the cost of property financed with tax-exempt bonds was eligible for recovery over the prescribed ACRS periods, but generally was not eligible for the accelerated cost recovery methods provided by ACRS (sec. 168(f)(12)). Projects for multifamily residential rental property (former sec. 103(b)(4)(A)) were not subject to this restriction, and therefore could qualify for both tax-exempt financing and accelerated ACRS deductions.

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[38] Because ownership of bond-financed property was treated as use of bond proceeds, property owned by nongovernmental persons (other than section 501(c)(3) organizations) generally could be financed only with IDBs and mortgage revenue bonds.

Information reporting requirements

Under prior law, issuers of IDBs, student loan bonds, bonds for section 501(c)(3) organizations, and all mortgage revenue bonds were required to report certain information to the Treasury Department about bonds issued by them during each calendar quarter. This report was due on the 15th day of the second month after the close of the calendar quarter in which the bonds were issued. Interest is taxable on bonds with respect to which a required report is not made.

Financing of issuance costs

No specific limits were placed on the financing of issuance costs with the proceeds of tax-exempt bonds.

Reasons for Change

General considerations

Congress was concerned with the large and increasing volume of tax-exempt bonds being issued under prior law. The effects of this increasing volume included an inefficient allocation of capital; an increase in the cost of financing traditional governmental activities; the ability of higher-income persons to avoid taxes by means of tax-exempt investments; and mounting revenue losses.

At the same time, Congress recognized the important cost savings that tax-exempt financing could provide for State and local governments, in a period marked by reductions in direct Federal expenditures for such purposes. To the extent possible, Congress desired to restrict tax-exempt financing for private activities without affecting the ability of State and local governments to issue bonds for traditional governmental purposes.

Between 1975 and 1985, the volume of long-term tax-exempt obligations for private activities (including tax-exempt IDBs, student loan bonds, mortgage revenue bonds, and bonds for use by certain nonprofit charitable organizations) increased from $8.9 billion to $116.4 billion. As a share of total State and local government borrowing, financing for these activities increased from 29 percent to 53 percent. Essentially, these bonds provided an indirect Federal subsidy to private activities. This affected the efficiency and equity of the tax system in several ways.

First, the large volume of nongovernmental tax-exempt bonds increased the interest rates that State and local governments were required to pay to finance their activities. As the total volume of tax-exempt bonds increases, the interest rate on the bonds must increase to attract investment from competing sources. The additional bond volume caused by nongovernmental use thus increases the cost of financing essential government services.

Second, tax-exempt financing for certain activities of nongovernmental persons resulted in a misallocation of capital. Efficient allocation of capital requires that the return from a marginal unit of investment be equal across activities. This can result, in turn, only if there is no preferential treatment for investment in certain activities. By restricting the ability of nongovernmental activities to qualify for tax-exempt financing, the Act reduces preferential treatment for certain activities and allows capital to be allocated more efficiently.

Third, the equity of the tax system was harmed as high-income taxpayers and corporations limited their tax liability by investing in tax-exempt securities. Because of the large volume of nongovernmental tax-exempt obligations, tax-exempt yields were often close to taxable yields. Taxpayers with high marginal tax rates accordingly received an after-tax yield on tax-exempt bonds significantly higher than the yield they would have received from taxable investments. A perception of inequity arises when such investors are able to reduce their tax liability and still receive a rate of return nearly as high as that on taxable investments.

Finally, rapid growth in the issuance of nongovernmental tax-exempt bonds resulted in mounting revenue losses.

Bonds for governmental activities

The Act retains the ability of qualified governmental units to issue tax-exempt debt for the financing of traditional governmental activities. These include general government operations and the construction and operation of such governmental facilities as schools, roads, government buildings, and governmentally owned and operated sewage, solid waste, water, and electric facilities.

While retaining the ability to issue bonds for governmental purposes, Congress was concerned that, under prior law, a significant amount of bond proceeds from governmental issues was being used to finance private activities not specifically authorized to receive tax-exempt financing. Abuses were noted whereby governmental bond issues were structured intentionally to maximize private use without violating the 25-percent private use limit of prior law. Other bond issues were intentionally structured to "fail" the prior-law IDB security interest test, when the bonds otherwise would be considered IDBs or would not qualify for tax-exemption. Congress believed that this diversion of governmental bond proceeds to nongovernmental users should be limited, but without setting the threshold amount so low that *de minimis* or incidental usage of government facilities and services by private users might cause interest on an issue to be taxable.

To accomplish this, the Act generally defines as a private activity (*i.e.*, nongovernmental) bond any bond of which more than 10 percent of the proceeds is to be used in a trade or business of any person or persons other than a governmental unit, and which is to be directly or indirectly repaid from, or secured by, revenues from a private trade or business. (This is similar to the IDB definition of prior law.) Additionally, a bond is a private activity bond if an amount exceeding the lesser of 5 percent or $5 million of the proceeds is to be used for loans to any person or persons other than a governmental unit. Congress believed that these rules provide an appropriate limit for preventing the diversion of governmental bond proceeds for conduit financing for nongovernmental users, without affecting the availability of tax-exempt financing for traditional governmental activities. The Act also modifies the prior-law security interest test to include certain indirect private payments, including payments which may have been structured with the intent of circumventing the test.

Congress recognized that State and local governments can, in certain cases, achieve significant cost efficiencies through joint public-private partnerships that utilize private management skills to assist in the provision of governmental services. Congress believed that properly restricted private management contracts should not prevent qualified governmental units from issuing tax-exempt obligations to finance the provision of these services. The Act accordingly liberalizes prior law by expanding the scope of private management contracts that are permitted in conjunction with governmental tax-exempt financing.

Exceptions for certain private activity bonds

In general

The Act continues certain exceptions to the general rule that interest on bonds for persons other than State and local governmental units, referred to collectively as private activity bonds, is taxable. These include many of the exceptions allowing such financing under prior law.[39]

Bonds for section 501(c)(3) organizations

The Act generally continues the substantive prior-law treatment of bonds issued for section 501(c)(3) organizations, to the extent the proceeds of those bonds are used to finance activities that are directly related to the exempt purpose of the organization. Congress believed that the services provided to the general public by these organizations warrant continued availability of tax-exempt financing without regard to State volume limitations. Certain restrictions imposed on other private activity bonds, including a public approval requirement and a limit on bond-financed issuance costs, are extended to these bonds.

State private activity bond volume limitations

While continuing tax-exempt financing for certain activities of nongovernmental persons, Congress believed it important to control the total volume of tax-exempt bonds issued for such activities. To accomplish this, the Act provides a limitation on the aggregate annual amount of private activity bonds that each State (including local governments therein) may issue. Congress believed that this new private activity bond volume limitation will ensure that the activities for which private activity bonds are issued will be scrutinized more closely by governmental units, and that such bonds will be targeted better to serve those persons and activities for which the exceptions are intended. Imposition of a single volume limitation, in place of the separate limitations imposed under prior law, was intended to allow State and local governments flexibility in allocating this limited Federal subsidy among qualifying activities.

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[39] The Act permits issuance of tax-exempt private activity bonds if the bonds are exempt-facility bonds (bonds for airports, docks and wharves, mass commuting facilities, water-furnishing facilities, sewage and solid waste disposal facilities, facilities for the local furnishing of electricity or gas, local district heating or cooling facilities, qualified hazardous waste disposal facilities, and multifamily residential rental projects), qualified small-issue bonds, certain mortgage revenue bonds, qualified 501(c)(3) bonds, qualified student loan bonds, and qualified redevelopment bonds.

In addition to private activity bonds, Congress intended that the substantial diversion of governmental bond proceeds to nongovernmental persons be scrutinized strictly by State and local government issuers. Therefore, the Act includes in the new State private activity bond volume limitations the portion of governmental bond proceeds, in excess of $15 million, that is to be used by nongovernmental persons. Subjecting this financing to the private activity bond volume limitations provides parity with the treatment accorded other tax-exempt financing for nongovernmental persons.

Congress understood the importance of solid waste disposal facilities to many communities, and that such facilities can frequently be operated more efficiently by private contractors. Congress believed that, where solid waste disposal facilities are owned by governmental units, operation by private parties should not cause financing for these facilities to be treated differently from that for comparable governmentally owned and operated facilities. Therefore, the Act does not subject tax-exempt financing for governmentally owned solid waste facilities to the new private activity bond volume limitations. Other bonds not subject to the volume limitations include bonds for airports, docks and wharves (facilities which also must be governmentally owned under the Act), and qualified 501(c)(3) bonds.

Targeting and other restrictions

Congress believed that tax-exempt bonds for nongovernmental persons should be used, to the extent possible, only for an activity for which financing specifically has been approved. Under prior law, up to 10 percent of the proceeds of various nongovernmental bonds could be used for nonqualifying activities without violating the conditions for tax-exemption of interest on these bonds (the so-called "substantially all" test). The Act generally limits this amount to five percent (the five-percent "bad money" portion). To prevent excessive diversion of bond proceeds to underwriters, attorneys, and other intermediaries, the Act further limits (generally to 2 percent) the amount of private activity bond proceeds that may be used to finance issuance-related costs and includes all bond-financed issuance costs in the five-percent bad money portion.

In the case of bonds for multifamily residential rental property and mortgage revenue bonds, Congress believed it important that bond proceeds be better targeted to provide rental housing for low-income families, or to assist families who otherwise would not be likely to purchase a first home. The Act includes several new income and other targeting requirements, as well as annual reporting requirements, to accomplish this objective. (The new rental housing targeting requirements are consistent with those adopted for purposes of the low-income housing credit (*see*, Title II., Part E.2., above)).

Arbitrage restrictions

The lower borrowing cost obtained through tax-exempt bonds provides the potential to earn arbitrage profits by investing tax-exempt bond proceeds at higher, taxable yields, unless such transactions are restricted. Arbitrage transactions have no economic substance, but are made profitable solely through the ability to borrow at tax-exempt rates. The ability to earn and retain arbitrage profits provides a substantial incentive for qualified governmental units to issue more bonds, to issue them earlier, and to leave them outstanding longer than they otherwise would. Arbitrage is an inefficient alternative to additional borrowing, because it is more costly to the Federal Government in terms of foregone tax revenue than the additional borrowing that would be necessary to produce the same amount of proceeds. It also may become a means for inflating bond financing beyond the intended volume limits. The Act adopts a number of provisions which restrict the ability of issuers of tax-exempt bonds to earn and retain arbitrage profits.

The Act requires issuers of tax-exempt bonds to rebate to the Federal Government most arbitrage earned from investment of tax-exempt bond proceeds. Congress chose to require rebate of arbitrage profits because it believed that prohibiting earning of any profits (*e.g.*, through elimination of temporary periods and other exceptions to the arbitrage yield restrictions) could prove unduly burdensome administratively. The rebate requirement is more flexible than—but substantively equivalent to—prohibiting the earning of arbitrage profits, a move that Congress initially took on a more limited scale in 1969.[40] To limit any significant administrative burden associated with the arbitrage rebate, the Act requires that the Treasury Department modify its State and Local Government Series (SLGS) program to offer demand deposits that eliminate rebatable arbitrage (in addition to fixed deposits as offered under prior law). In addition, exceptions to the arbitrage rebate requirement are provided for governmental bonds of issuers who do not expect to issue more than $5 million in such bonds during the calendar year, and in situations where bond proceeds are fully expended for the governmental purpose of the issue within six months.

Congress believed that it is important for issuers of tax-exempt bonds to pay the costs associated with their borrowing. The Act provides that the costs of issuance, including attorneys' fees and underwriters' commissions, must be paid by the issuers or beneficiaries of the bonds, rather than recovered through arbitrage profits at the Federal Government's expense. In the case of private activity bonds, bond-financing of issuance costs is also restricted to 2 percent of bond proceeds (as described above). Congress believed that these restrictions will result in a more efficient use of tax-exempt financing, as borrowers more closely monitor the costs of their borrowing and eliminate unnecessary bond volume that often was issued "at no cost" to the borrower under prior law.

The Act prevents an abuse of tax-exempt financing by certain governmental units whereby bonds were issued for the purchase of annuity contracts (*e.g.*, to fund pension plan liabilities). These transactions were designed to avoid arbitrage restrictions that would apply to direct tax-exempt financing of liabilities. The Act treats investments in annuity contracts comparably with the direct funding of a pension plan.

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[40] A rebate requirement was applied to mortgage revenue bonds in 1980 and to most IDBs in 1984.

Congress also decided to restrict the advance refunding of tax-exempt bonds. Issuers of certain tax-exempt bonds—unlike private borrowers—had frequently advance refunded (*i.e.*, refunded outstanding bonds without retiring the old debt) at virtually no cost or risk, since the proceeds of an advance refunding may be invested in Federal securities at a guaranteed yield equal to that of the refunding issue. Advance refunding resulted in multiple issues of bonds being outstanding simultaneously, and thereby in multiple indirect Federal subsidies attributable to a single activity. For example, bonds for a single project costing $50 million might be advance refunded two or more times, so that the Federal Government would be subsidizing $150 million or more in tax-exempt bonds for one $50-million project. (This is unlike the refinancing of, *e.g.*, a home mortgage loan, in which the original loan is retired at the time of the refinancing.) The ability to advance refund bonds also encouraged tax-exempt borrowers to agree to covenants and other terms (*e.g.*, call protection) that other borrowers would reject.

Explanation of Provisions

1. General structure of bond provisions

The Act reorganizes and amends the prior-law rules governing tax-exemption for interest on obligations issued by (or on behalf of) qualified governmental units.[41] As part of this reorganization, the prior-law rules contained in Code sections 103 and 103A are divided, by topic, into 11 Code sections (secs. 103 and 141-150). Congress did not intend that this reorganization affect principles of prior law which, to the extent not amended, continue to apply under the reorganized provisions.[42]

In general, bonds[43] the interest on which is tax-exempt may continue to be issued by or on behalf of[44] qualified governmental units to finance activities of the governments themselves without regard to (1) the State volume limitations for private activity bonds and (2) many of the other restrictions that apply to bonds for nongovernmental persons.[45] (As discussed in 4., below, the new State private activity bond volume limitations apply to the nongovernmental use portion, in excess of $15 million, of a governmental bond.)

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[41] The term qualified governmental unit means a State or a possession of the United States, any political subdivision of the foregoing, and the District of Columbia. The term also includes Indian tribal governments, except that such tribal governments may not issue any private activity bonds, and to the extent bond volume authority is required for the nongovernmental portion of any large (*e.g.*, over $150 million) issue of governmental bonds, must receive the allocation of that authority from the private activity bond volume limitation of the State in which the bond-financed facilities are to be located.

[42] As under prior law, interest on certain bonds authorized by non-Code provisions of law is tax-exempt if the authorization was enacted before January 1, 1984, and the bonds comply with all appropriate Code requirements. The appropriate Code requirements include all requirements that apply to Code bonds with respect to which the use of bond proceeds is comparable, including (but not limited to) the new State private activity bond volume limitations, the arbitrage rules, the information reporting requirements, the limitation on bond-financing of costs of issuance, and the restrictions on tax-exempt bonds for certain activities.

[43] Under these rules, as under prior law, the term bond also includes debt obligations of a qualified governmental unit that do not involve the formal issuance of a bond or note. For example, installment purchase agreements, finance leases, and other evidences of debt issued pursuant to the borrowing power of a qualified governmental unit are treated as bonds.

[44] The Act continues the prior-law rule allowing bonds to be issued either by or on behalf of qualified governmental units. *See, e.g.*, Treas. Reg. sec. 1.103-1(b); Rev. Rul. 63-20, 1963-1 C.B. 24; and Rev. Proc. 82-26, 1982-1 C.B. 476.

[45] A nongovernmental person is any person, including the Federal Government and any of its agencies or instrumentalities, other than a State or local governmental unit.

Thus, under the Act, State and local governments may continue to provide tax-exempt financing for general government operations as well as for the construction and operation of such facilities as schools, highways, government buildings, and governmentally owned and operated sewage, solid waste disposal, water, and electric facilities. Additionally, qualified governmental units may continue to issue short-term notes in anticipation of taxes and other revenues (TANs and RANs) to finance cash-flow shortfalls. Similarly, interest on most debt of qualified governmental units that does not involve formal issuance of bonds (*e.g.*, installment purchase agreements and finance leases) is tax-exempt to the same extent that interest on formally designated bonds issued for the same purpose would be tax-exempt. As under prior law, interest paid by qualified governmental units other than pursuant to the exercise of their borrowing power is not tax-exempt (*e.g.*, interest on State income tax refunds).

The determination of whether an entity is a qualified governmental unit continues to be made in the same manner as under prior law. In general, therefore, an entity is a political subdivision (and therefore a qualified governmental unit) only if it has more than an insubstantial amount of one or more of the following governmental powers: the power to tax, the power of eminent domain, and the police power (in the law enforcement sense).[46]

Qualified governmental units also may continue to provide tax-exempt financing for certain nongovernmental activities. Bonds for activities of nongovernmental persons are referred to collectively as private activity bonds. All private activity bonds involve a use of bond proceeds or bond-financed property by, or a loan of bond proceeds to, a person other than a governmental unit, which use or loan exceeds a specified portion of the proceeds. Unlike financing for government operations, interest on private activity bonds is taxable unless a specific exception is provided in the Code. Tax-exempt private activity bonds, like bonds for governmental activities, may be issued by or on behalf of a qualified governmental unit.

Private activity bonds qualifying for tax-exemption include exempt-facility bonds, small-issue bonds, qualified mortgage bonds and qualified veterans' mortgage bonds, qualified 501(c)(3) bonds, qualified student loan bonds, qualified redevelopment bonds, and bonds issued as part of one of four specifically described programs.[47]

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[46] Congress was aware that certain State universities, hospitals, and other State or local government entities (including certain public benefit corporations) also have received determination letters regarding their tax-exempt status under Code section 501(c)(3). Congress intended that, to the extent of such an entity's activities as a qualified governmental unit, bonds for the entity will be treated as governmental bonds rather than as private activity bonds for activities of a section 501(c)(3) organization.

[47] These four programs are the Texas Veterans' Land Bond program, the Oregon Small Scale Energy Conservation and Renewable Resource Loan programs, and the Iowa Industrial New Jobs Training Program (subject to a limit of $100 million in outstanding bonds, including bonds issued before August 16, 1986). The prior-law sunset date for the Texas Veterans' Land Bond Program is deleted. Bonds issued as part of any of these programs are subject to all restrictions that generally apply to private activity bonds, including (but not limited to) the requirements that 95 percent or more of the proceeds of these bonds be used for the exempt purpose of the borrowing and that no more than 2 percent of bond proceeds be used to finance certain costs of issuance (described below), and the new State private activity bond volume limitations.

Exempt-facility bonds are bonds issued to finance airports, docks and wharves, mass commuting facilities, water-furnishing facilities, sewage disposal facilities, solid waste disposal facilities, qualified hazardous waste disposal facilities, facilities for the local furnishing of electricity or gas, local district heating or cooling facilities, or qualified multifamily residential rental projects. Facilities financed with such bonds must satisfy a public use requirement, discussed in 3., below.

Congress recognized that section 501(c)(3) organizations in many cases perform functions which governments otherwise would have to undertake. The use of the term private activity bond to classify obligations for section 501(c)(3) organizations in the Internal Revenue Code of 1986 in no way connotes any absence of public purpose associated with their issuance. Accordingly, the Act requires that any future change in legislation applicable to private activity bonds generally shall apply to qualified 501(c)(3) bonds only if expressly provided in such legislation.

The Act continues the prior-law provision treating certain bonds issued by volunteer fire departments as issued by qualified governmental units. Such bonds generally may be issued under similar conditions to those that applied under prior law, except that 95 percent of the bond proceeds are required to be used for the acquisition, construction, reconstruction, or improvement of a firehouse or firetruck used (or to be used) by the department. Additionally, qualified scholarship funding corporations may continue to issue qualified student loan bonds, subject to a requirement that any income of the corporation be devoted to the purchase of additional student loan notes or paid over to the United States.[48]

Congress was aware that, because of the new restrictions on tax-exempt bonds, issuers may in some cases wish to issue taxable and tax-exempt bond issues for discrete purposes[49] pursuant to a common financing plan. These bonds may be issued on the same date or within a short period of each other and may have the same or a similar security. Congress intended that the Treasury Department will adopt rules providing that such taxable and tax-exempt issues may be treated as separate issues in appropriate cases. These rules may require pro rata allocations (or such other allocations as may be prescribed by Treasury), of *e.g.*, maturities, reserve funds, and other expenditure purposes between the taxable and tax-exempt issues.[50]

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[48] Under prior law, such income was required to be used to purchase additional student loan notes or alternatively to be paid over to the State or a political subdivision chartering the corporation. In modifying this requirement, Congress did not intend that existing qualified scholarship funding corporations cease operations, pending modification of their articles of incorporation to reflect the revised law; rather, existing corporations may continue to operate as such provided that steps are taken to effect the necessary amendment to their articles of incorporation with reasonable speed. *See*, 132 Cong. Rec. E3392 (October 2, 1986) (statement of Mr. Rostenkowski).

[49] For this purpose, taxable financing of costs associated with a tax-exempt issue, in excess of the 2-percent maximum permitted to be financed with proceeds of the tax-exempt issue, is treated as a discrete purpose.

[50] Any rules adopted by Treasury pursuant to this direction will apply exclusively to cases involving both taxable and tax-exempt issues which finance discrete purposes which otherwise might be aggregated under existing Code and Treasury Department rules. Congress did not intend by this action to imply an intent to change the prior-law rules with respect to either (i) the circumstances in which multiple tax-exempt "issues" are treated as a single tax-exempt

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2. Definition of private activity bond

As under prior law, the term governmental bond is not directly defined in the Code. Rather, bonds are private activity bonds if (1) the bonds satisfy nongovernmental trade or business use and security interest tests (similar to the prior-law definition of IDBs), or (2) more than a specified amount of bond proceeds are to be used to make loans to a nongovernmental person or persons (similar to the prior-law private loan bond restriction). The Act also includes a special limitation on disproportionate private business use of bond proceeds that is unrelated to the governmental purpose of the issue.

a. Private business tests

General rules

Under the Act, an issue is an issue of private activity bonds if—

(1) an amount exceeding 10 percent of the proceeds[51] is to be used (directly or indirectly) in any trade or business carried on by any person other than a governmental unit (the "trade or business use" test), and

(2) more than 10 percent of the payment of principal or interest on the issue is to be made (directly or indirectly, and whether or not to the issuer) with respect to such a trade or business use of the bond proceeds, or is otherwise secured by payments or property used in a trade or business (the "security interest" test).[52]

Trade or business use test

The Act generally retains the prior-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test. Thus, the use of bond-financed property is treated as use of bond proceeds.[53] As under prior law, a person may be a user of bond proceeds and bond-financed property as a result of (1) ownership or (2) actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or (3) any other arrangement such as a take-or-pay or other output-type contract. Use (including use as an industrial customer) on the same basis as the general public is not taken into account. However, trade or business use by all persons on a basis different from the general public is aggregated in determining if the 10-percent threshold is exceeded.[54]

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issue or (ii) the treatment of an entire tax-exempt issue (including issues treated as a single issue) as a private activity issue if the private business tests or the private loan test are satisfied. Thus, private use and governmental use portions of a tax-exempt issue may not be treated as separate issues pursuant to this direction where such separate treatment was precluded under prior law. (The Act includes one limited exception to this rule under which the governmental and 501(c)(3) organization use portions of an issue may be treated as separate issues if certain requirements are satisfied.)

[51] In determining the amount of proceeds for purposes of the 10-percent business use and security interest tests and the private loan restriction, costs of issuance and amounts invested in a reasonably required reserve or replacement fund are allocated between the governmental use and private use portions of the issue.

[52] As described below, the 10-percent limit is reduced to the lesser of 10-percent or $15 million per facility in the case of financing for output facilities (other than water facilities.)

[53] Similarly, the use of bond proceeds is treated as use of any property financed with the proceeds.

[54] Congress was aware that, under Treasury Department rules, limited use of facilities by nongovernmental persons on a basis unlike that of the general public was disregarded in certain

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For purposes of the trade or business use test, all activities of section 501(c)(3) organizations, the Federal Government (including its agencies and instrumentalities), and other persons (other than State and local governments) who are not natural persons are treated as trade or business activities.[55]

The determination of who uses bond proceeds or bond-financed property generally is made by reference to the ultimate user of the proceeds or property. As under prior law, however, the proceeds of an issue generally are not treated as used in any trade or business of a nongovernmental person when the proceeds are used to pay for services rendered to the government or to defray other liabilities of a governmental unit arising from general government operations. For example, bond proceeds used to purchase a computer to be owned and used by the purchasing governmental unit are not treated as used in the computer company's business. Likewise, bond proceeds used to satisfy contractual obligations undertaken in connection with general governmental operations, such as payment of government employees' salaries, or to pay legal judgments against a governmental unit, are not treated as used in the business of the payee. This is to be contrasted with the indirect nongovernmental use of bond proceeds that occurs when a government contracts with a nongovernmental person to supply that person's trade or business with a service (*e.g.*, electric energy) on a basis different from that on which the service is provided to the public generally or to finance property used in that person's business (*e.g.*, a manufacturing plant). In both of these instances a nongovernmental person is considered to use the bond proceeds other than as a member of the general public.

Many States provide for the creation of tax or utility districts that may themselves be qualified governmental units to provide essential governmental functions to an area within a larger governmental unit for which development is planned. During an initial development period, the land in such a district may be owned by a single developer (*e.g.*, a redevelopment agency), or a limited group of developers, who are proceeding with all reasonable speed to develop and sell the land to members of the general public for residential or commercial use. Congress intended that bond proceeds used in such situations to finance facilities for essential governmental functions such as extensions of municipal water systems; street paving, curbing (including storm water collection), and sidewalk and street-light installation; and sewage disposal generally not be treated as used in the trade or business of the developers. Rather, the tax status of the bonds generally will be determined by

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cases. *See, e.g.*, Treas. Reg. sec. 1.103-7(c), Examples (6) and (11); Rev. Proc. 82-14, 1982-1 C.B. 459; and Rev. Proc. 82-15, 1982-1 C.B. 460. *See also*, Treas. Reg. sec. 1.103-7(b)(3) and Rev. Rul. 77-352, 1977-2 C.B. 34. Neither these rules, nor the Treasury Department's general authority to determine what constitutes (or does not constitute) a use of bond proceeds, is modified by the Act. (*But see*, note 60, below, regarding the modification of certain *de minimis* rules pertaining to output facilities.)

[55] The Act provides a special exception under which use of bond proceeds by the Bonneville Power Administration (BPA) will continue to be treated as use by a governmental unit to the extent that BPA was treated as an exempt person under a transitional exception contained in prior-law Treasury Department regulations. (*See*, Act sec. 1316(d) and Treas. Reg. sec. 1.103-7(b)(2)(iii).)

reference to the ultimate (*i.e.*, after the initial development period) use of the facilities.

Security interest test

The Act retains and expands the prior-law security interest test. Under this revised test, both direct and indirect payments made by any person (other than a governmental unit) who is treated as using the bond proceeds are counted. Such payments are counted whether or not they are formally pledged as security and whether or not they are directly used to pay debt service on the bonds. Similarly, payments to persons other than the issuer of the bonds are taken into account. For example, payments made by a lessee of bond-financed property to a redevelopment agency are considered under the test even though the city, as opposed to the redevelopment agency, actually issues the bonds and does not receive the payments from the redevelopment agency.

Payments from persons who are not treated as using the bond proceeds under the trade or business use test, described above, are not counted unless the payments are pledged to pay debt service or otherwise satisfy the prior-law security interest test.

Revenues from generally applicable taxes are not treated as payments for purposes of the security interest test. Congress intended, however, that special charges imposed on persons satisfying the private business use test (but not on members of the public generally) would be taken into account if the charges are in substance amounts paid for the use of bond proceeds.

For example, where bonds are used to acquire land that is to be sold to private persons for redevelopment, amounts paid by those persons for the land are payments for purposes of the security interest test, even though incremental property tax revenues or the full faith and credit of the issuer are the stated security for the bonds. This is the case whether the payments are made in a lump sum or in installments. Similarly, if a facility is leased to a nongovernmental user and receipts from a tax are formally pledged as security, lease payments from the private user are considered for purposes of the security interest test, even if the tax revenues (rather than the lease or other payments) comprise the direct source for repayment of the bonds.

Use pursuant to certain management contracts

The Act directs the Treasury Department to liberalize its published advance ruling guidelines regarding treatment of nongovernmental use pursuant to certain management contracts. (*See,* Rev. Proc. 82-14, *supra.*) The modified guidelines are to provide that a nongovernmental person's use of bond-financed property pursuant to a management contract is not treated as private trade or business use if—

(1) the term of a management contract does not exceed five years (including renewal options);

(2) at least 50 percent of the compensation to any manager other than a governmental unit is on a periodic, fixed-fee basis,[56] and no amount of compensation is based on a share of net profits; and

(3) the governmental unit owning the facility may terminate the contract (without penalty) at the end of three years.[57]

Except for the changes indicated, Congress did not intend to require the Treasury Department to alter its prior-law advance ruling guidelines and regulations for determining when nongovernmental use is disregarded for purposes of the trade or business use test or to limit the Treasury Department's authority to determine what constitutes (or does not constitute) a use of bond proceeds.[58]

Use pursuant to certain cooperative research agreements

Congress was aware that the conduct of basic research is an integral function of universities, and that State universities may enter into cooperative agreements with nongovernmental persons for the conduct of such basic research. The findings in connection with research conducted at these facilities are disseminated to the general public through various scientific and technical journals. Title to any patents incidentally resulting from the research conducted pursuant to the cooperative arrangement lies exclusively with the educational institution, and not with any nongovernmental person.

Congress intended that use of bond-financed property by nongovernmental persons pursuant to such a cooperative research arrangement is not to be considered when determining the degree of nongovernmental use of the property provided that the use occurs under either of the following types of arrangements.

First, a university facility may be used for corporate-sponsored research as long as any license or other use of resulting technology by the sponsoring party is permitted only on the same terms as the university would permit such use by any nonsponsoring unrelated party; that is, the sponsor must pay a competitive price for its use of the technology. Thus, the sponsoring university is not actually required to grant use of the technology to any other party; however, the sponsoring party must pay a price for the use of any resulting technology that is the same as a nonsponsoring party would pay. Further, that price must be determined at the time the technology is available for use rather than an earlier time (*e.g.*, when the research agreement is entered into).

Second, facilities used pursuant to joint industry-university cooperative research arrangements may be eligible for tax-exempt financing where, as under most such arrangements currently sponsored by the National Science Foundation—

(1) multiple, unrelated industry sponsors agree to fund university-performed basic research;

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[56] The periodic, fixed-fee may be subject to an annual cost of living adjustment but may not be subject to any incentive adjustment (*e.g.*, based on the output or efficiency of the project). (*See*, section 3.01 of Rev. Proc. 82-14, *supra*.)

[57] Congress intended that a similar change will be made to the advance ruling guidelines as applied to qualified 501(c)(3) bonds. (*See*, Rev. Proc. 82-15, 1982-1 C.B. 460.) *Cf.*, the continuing allowance of certain more liberal rules for section 501(c)(3) organizations, described in note 58, below.

[58] For example, the provision of Rev. Proc. 82-15, which disregards certain private use pursuant to management contracts of up to two years where compensation is exclusively on a percentage basis, is not altered by this direction to Treasury. (*See*, sec. 3.01 of Rev. Proc. 82-15, *supra*.)

(2) the research to be performed and the manner in which it is to be performed is determined by the university;

(3) title to any patent or other product incidentally resulting from the basic research lies exclusively with the university; and

(4) sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any such research.

Congress further understood that section 501(c)(3) universities may enter into cooperative arrangements similar to those described in the preceding two paragraphs, and intended the same rules to apply in determining whether proceeds of bonds for these organizations are used in a private business use.

Special rules for certain output facilities

In general

The Act provides a special limit on bond financing for output facilities used by persons other than governmental units or members of the general public.[59] In the case of bonds 5 percent or more of the proceeds of which are to be used to finance output projects such as electric and gas generation, transmission, and related facilities (but not water facilities), the maximum amount of bond-financing that may be used by nongovernmental persons on a basis other than as a member of the general public is $15 million.[60] Thus, with respect to any such issue, the amount of bond proceeds used by such persons may not exceed the lesser of 10 percent or of $15 million of the proceeds.[61] In determining whether the $15-million limit is exceeded, all prior issues issued with respect to a project are counted.[62] Application of this restriction may be illustrated by the following examples:

Example 1.—Assume that a single issue of tax-exempt bonds is contemplated to finance the acquisition of an electric generating facility for $500 million. Assume further that 10 percent of the facility will be owned by an investor-owned utility. The maximum amount of tax-exempt financing that may be provided for the acquisition is $465 million (*i.e.*, $450 million for the 90 percent of the facility that is governmentally owned, and a maximum of $15 million for the privately owned portion).

Example 2.—Alternatively, assume that the facility in Example 1 is financed with four bond issues. Assume further that the first issue is for $100 million. The maximum private use portion for this issue is $10 million (10 percent of the issue). Assume a second issue of $150 million with respect to the facility. The maximum permitted private use portion for the second issue is $5 million ($15 million less the $10-million private use portion of the first issue). For all subsequent issues for the facility, no private use financing would be permitted.

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[59] This special limit does not change the determination of when a nongovernmental person is treated as a user of bond proceeds, *e.g.*, in the case of facilities that are used in part by governmental utilities and in part by investor-owned utilities.

[60] The Act directs the Treasury Department to modify its existing regulations (Treas. Reg. sec. 1.103-7(b)(5)) for determining the portion of an output facility that is privately used to delete the special exception under which users of three percent or less of the output of a facility were disregarded in determining whether an issue satisfied the trade or business use and security interest tests.

[61] A parallel reduction applies to the security interest test.

[62] Issues that were issued before September 1, 1986, together with all subsequent issues, are counted for purposes of applying this limit to issues that are issued after August 31, 1986.

Use pursuant to certain pooling and exchange arrangements and certain spot sales of output capacity

Although sales of power to investor-owned utilities pursuant to output or requirements contracts are intended to be counted for purposes of the private business tests, Congress wished to clarify that certain power pooling and exchange arrangements and certain spot sales of output capacity are treated as sales to the general public under those tests. Under this clarification, the presence of a nongovernmental person acting solely as a conduit for exchange of power output among governmentally owned and operated utilities is to be disregarded in determining whether the private business tests are satisfied. In addition, exchange agreements that provide for "swapping" of power between governmentally owned and operated utilities and investor-owned utilities do not in any event give rise to private business use where (1) the "swapped" power is in approximately equivalent amounts determined over periods of one year or less, (2) the power is swapped pursuant to an arrangement that does not involve output-type contracts, and (3) the purpose of the agreements is to enable the respective utilities to satisfy differing peak load demands or to accommodate temporary outages.[63]

Additionally, spot sales of excess power capacity for temporary periods, other than by virtue of output contracts with specific purchasers, are not treated as private business use of bond proceeds. For purposes of this exception, a spot sale is a sale pursuant to a single agreement that is limited to no more than 30 days' duration (including renewal periods).

b. Unrelated use restriction

Under the Act, the private business use threshold is reduced to five percent in the case of a private business use which use (and payments in respect of such use) is (i) unrelated to any governmental use also being financed with the issue, or (ii) disproportionate to the related governmental use being financed.[64] If the sum of all such unrelated private business uses financed with the proceeds of an issue exceeds 5 percent of the issue proceeds (and a 5-percent security interest test determined with respect to such use is satisfied), then the issue is an issue of private activity bonds.

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[63] The Bonneville Power Administration (BPA) is involved in two types of pooling and exchange arrangements as part of its statutory responsibility to manage the Federal hydroelectric system in the Northwest. The first uses coordination agreements, in which both governmentally-owned and investor-owned utilities make power available to a power pool. Each utility has the right to draw power from the pool which approximately equals the amount of power made available to the pool. Because of unique issues arising from variations in rainfall, snowfall, and runoff, some of these agreements have to utilize a 4-year critical water planning period to coordinate the use of each utility's hydroelectric resources in a manner that is most efficient for the region as a whole. The second arrangement involves residential purchase and sale agreements mandated by the Northwest Regional Power Act. Under these agreements, BPA exchanges power with both governmentally-owned and investor-owned utilities for the purpose of spreading the costs and benefits of Federal hydroelectric energy to the residential customers of these utilities. Congress intended that neither of these pooling arrangements, as constituted on October 22, 1986, gives rise to a trade or business use of bond proceeds on the part of BPA. (*See*, 132 Cong. Rec. H8363 (September 25, 1986) (statement of Mr. Rostenkowski); 132 Cong. Rec. S13936 (September 27, 1986) (colloquy between Senator Packwood and Senator Gorton).

[64] Congress was aware that certain governmental financings (as opposed to private activity bond financings) historically have been accomplished on a composite basis with multiple governmental facilities receiving funding from regularly scheduled issues on a "current disbursements" basis. Congress intended that, to the extent permitted by the Treasury Department, the unrelated and disproportionate use requirements may be applied in such cases on the basis of total financing for a facility rather than on an issue-by-issue basis if, for example, the total amount of financing for the facility (including both governmental and private use portions) is specified in a detailed plan adopted in advance of initial financing for the facility.

The determination of whether a private business use is related to a governmental use also being financed with the bond proceeds is to be made on a case-by-case basis, emphasizing the operational relationship between the governmental and nongovernmental uses. In most—but not all—cases, this will result in a related private-business-use facility being located within or adjacent to the governmental facility to which it is related. For example, a newsstand located in a courthouse is related to the courthouse, and a privately operated school cafeteria is related to the school in which it is located. By contrast, the use of 6 percent of school bond proceeds to build an administrative office building for a catering company that operates cafeterias for the school system is not a related use of bond proceeds and would result in interest on the bond issue from which the proceeds are derived being taxable. Similarly, office space for lawyers engaged in the private practice of law is not related to financing of a courthouse or other government building in which the offices may be located.

Private business use financing provided with bond proceeds in excess of the unrestricted 5-percent private use portion generally must be proportionate to the amount of bond proceeds used for a related governmental use also financed with proceeds of the issue.[65] The determination of whether a private business use is proportionate to the governmental use to which it relates is determined by comparing the amount of bond proceeds used for the related private business and governmental uses. The related private business use is disproportionate to the related governmental use to the extent it exceeds such use in amount. Multiple private-business-uses which are related to any one governmental use are aggregated in applying this restriction.

Example 1.—Assume County X issues $20 million of bonds for construction of a new school building and decides to use $18.1 million of the proceeds for construction of the new school building and $1.9 million of the proceeds for construction of a privately operated cafeteria in the county's administrative office building. The $1.9 million of proceeds is not related to the governmental use (*i.e.*, school construction) being financed with the bonds; thus interest on the bonds is taxable. Had County X limited use of bond proceeds for the privately operated cafeteria to $1 million, however, the unrelated private use restriction would not be violated since the amount of unrelated private business use would not have exceeded 5 percent of the proceeds of the issue.

Example 2.—Assume City Y issues $50 million of bonds for construction of a new public safety building ($32 million) and for improvements to an existing courthouse ($15 million). (The maximum private business use (related and unrelated) portion for these bonds is $5 million, and the maximum unrelated private business use portion is $2.5 million.) Assume further that Y decides to use $3 million of the bond proceeds for renovation of an existing privately operated cafeteria located in the courthouse. If there is no other private business use financed with the bonds, Y's use of the $3 million for the privately operated cafeteria does not violate the unrelated use restriction. These expenditures are treated as being derived first from the permitted related private use portion (up to $2.5 million), and then from the unrelated private business use portion ($0.5 million).

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[65] Under the general test for private activity bonds, all private use financing (including related and unrelated private use financing provided from an issue) may not exceed 10 percent of the proceeds of the issue.

Example 3.—Assume the facts of Example 2, except City Y decides to use $1.5 million of the bond proceeds to construct a privately operated parking garage adjacent to its new public safety building (reducing the proceeds available for the public safety building to $30.5 million). Under these facts, the allocation for the privately used courthouse facilities is determined as in Example 2. The expenditures for the public safety building parking garage are treated as derived from the unrelated private use portion ($1.5 million) since the entire 5-percent related private use portion for the issue was used for the courthouse cafeteria. Thus, the unrelated use restriction is not violated.

c. Private loan restriction

A bond is a private activity bond if an amount exceeding the lesser of 5 percent or $5 million of bond proceeds is to be used (directly or indirectly) to make or finance loans to any person other than a governmental unit.

As under the prior-law private loan restriction, a loan may arise from the direct lending of bond proceeds or from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction, as opposed to its form. For example, a lease or other contractual arrangement (*e.g.*, a management contract or an output or take-or-pay contract) may in substance constitute a loan, even if on its face, such an arrangement does not purport to involve the lending of bond proceeds.[66] However, a lease or other deferred payment arrangement with respect to bond-financed property that is not in form a loan of bond proceeds generally is not treated as such unless the arrangement transfers tax ownership of the property to a nongovernmental person. Similarly, an output or management contract with respect to a bond-financed facility generally is not treated as a loan of bond proceeds unless the agreement in substance shifts significant burdens and benefits of ownership to the nongovernmental purchaser or manager of the facility.[67]

An exception to the private loan restriction is provided for the financing technique accomplished with obligations known as tax-assessment bonds. Under this exception, the deemed loans arising from mandatory taxes or other assessments of general application

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[66] Additionally, if a governmental unit transfers property to a nongovernmental person in exchange for a right to all or any portion of the income from the property, the transfer may involve a loan.

[67] As under prior law, a use arises in every case in which a loan is present. A private loan bond may not satisfy the private business tests, however, in cases in which (*e.g.*) the loan is made to an individual not engaged in a trade or business.

(as opposed to fees for services) for specific, essential governmental functions (as opposed to installment payments of property or other taxes generally) that a governmental unit permits its residents to pay over a period of years are disregarded in determining if interest on the bonds is tax exempt. Instead, the determination is made based upon the use of the facilities or services being financed or the making of loans that are not disregarded under the exception. Examples of the limited types of activities that may be treated as essential governmental functions under this exception include street paving and street-light installation, sewage treatment and disposal, and municipal water facilities.

Congress understood that the method of assessing residents for these improvements varies from State to State. Taxes or other mandatory assessments with respect to the improvements serving an essential governmental function may be levied on a property frontage basis or on an *ad valorem* basis. Congress intended that deemed loans for these purposes be disregarded in determining the tax status of bonds whether the taxes or other assessments are based on a property frontage basis, an *ad valorem* basis, or any other comparable method that results in equivalent mandatory assessments to all residents benefiting from the specific governmental improvements financed with the bond proceeds.

Congress also wished to clarify the application of this rule to taxes or other assessments levied on property used in a trade or business. Congress intended that this exception apply when the assessed property is used in a trade or business as well as when the assessed property is used for nonbusiness purposes. In such cases, the exception applies only if the tax or other assessment is mandatory and for a specific essential governmental function and only if owners of both business and nonbusiness property benefiting from the improvements financed with the bonds are eligible to make deferred payments of such tax or assessment on an equal basis. As in the case of loans made exclusively to persons not engaged in a trade or business, the character of the improvement being financed (*i.e.*, the ultimate use of the bond proceeds) rather than the presence of the indirect loan determines the tax status of the bonds. For example, bonds issued in connection with a governmentally owned and operated sewage disposal system may be governmental bonds despite the fact that both individual and business residents of the governmental unit who use the system are permitted to pay taxes or assessments levied in connection with its installation in installments. In contrast, bonds for a similar privately managed sewage disposal system serving the general public would be tax-exempt only if they satisfy the requirements applicable to exempt-facility private activity bonds.

3. Exceptions for certain private activity bonds

a. Exempt-facility bonds

In general

Interest on certain exempt-facility bonds[68] issued by or on behalf of qualified governmental units may be tax-exempt even though the trade or business use and security interest tests, the related use test, and/or the private loan test (described above) for identifying private activity bonds are satisfied. As stated above, exempt facilities eligible for tax-exempt financing include airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage disposal facilities, solid waste disposal facilities, facilities for the local furnishing of electricity or gas, local district heating or cooling facilities, qualified hazardous waste disposal facilities, and qualified residential rental projects.

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[68] Bonds for these activities generally were classified as exempt-activity IDBs under prior law.

Airports

The Act allows exempt-facility bonds to be issued to finance airports and related storage or training facilities. The term airport for this purpose includes property that could be financed with exempt-activity airport IDBs under prior law, except that the term specifically does not include any of the following facilities if used in a private business use:

(1) Hotels (or other lodging facilities).

(2) Retail facilities (including food and beverage facilities) located in a terminal, if the facilities are in excess of a size necessary to serve passengers[69] and employees at the airport.

(3) Retail facilities for passengers or the general public (including, but not limited to, rental car lots) located outside the terminal.[70]

(4) Office buildings for individuals who are not employees of a governmental unit or of the public airport operating authority.

(5) Industrial parks or manufacturing facilities.

Congress was aware that, in certain cases, airport terminal and other facilities may be used in part for activities qualifying for exempt-facility bond financing and in part for other purposes. In determining the portion of costs of such mixed-use airport facilities to be financed with exempt-facility bonds, the cost of nonqualified facilities include only the structural components required for the nonqualified portion of the facility (*e.g.*, interior walls, partitions, ceilings, and special enclosures) and the interior furnishings of that facility (*e.g.*, additional plumbing, electrical, and decorating costs). The costs of the general components of the terminal or other airport facility, such as land, structural supports, and exterior walls, are not required to be allocated to property ineligible for exempt-facility bond financing to the extent that these general components are required for the remaining portion of the airport (assuming the nonqualified facility had not been built and assuming the qualified facility could be correspondingly smaller).[71]

Docks and wharves

Exempt-facility bonds may be issued under the Act to finance docks and wharves and related storage or training facilities. The term dock and wharf includes all property that could be financed with exempt-activity dock and wharf IDBs under prior law, except that the term specifically does not include facilities equivalent to those the financing of which is prohibited with exempt-facility airport bonds,[72] if such facilities are used in a private business use. Congress intended that the treatment of mixed-use facilities (or portions of facilities) be similar to that described in the discussion of airport bonds, above.

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[69] For purposes of these limitations, the term passengers includes persons meeting or accompanying persons arriving and departing on flights to and from the airport.

[70] Public parking is not treated as a retail facility for purposes of this limitation, but such parking must be limited to no more than a size necessary to serve passengers and employees at the airport.

[71] *See below,* for governmental ownership requirement for all property financed with exempt-facility bonds for airports, docks and wharves, and mass commuting facilities.

Mass commuting facilities

Under the Act, exempt-facility bonds may be issued to finance mass commuting facilities and related storage or training facilities. As in the case of airports and docks and wharves, the term mass commuting facility includes property that could be financed with exempt-activity IDBs for mass commuting facilities under prior law,[73] except that the term specifically does not include facilities equivalent to those the financing of which is prohibited with exempt-facility airport bonds,[74] if such facilities are used in a private business use. The treatment of mixed-use facilities (or portions of facilities) is to be similar to that described in the discussion of airport bonds, above.

Facilities for the furnishing of water

The Act allows exempt-facility bonds to be issued to finance facilities for the furnishing of water, defined in the same manner as facilitates for which exempt-activity IDB financing was permitted under prior law.[75] This includes facilities used to furnish water for irrigation purposes.

As under prior law, water-furnishing facilities qualify for exempt-facility bond financing only if the water is made available to the general public, including electric utility, industrial, agricultural, or commercial users. Furthermore, a qualifying facility must be operated by a governmental unit; alternatively, the rates for the furnishing or sale of the water must be established or approved by a governmental unit, United States agency, or State or local public service or public utility commission.

Sewage disposal facilities

The Act allows exempt-facility bonds to be issued to finance sewage disposal facilities, defined in the same manner as under the prior-law exception for exempt-activity IDBs for sewage disposal facilities.

Solid waste disposal facilities

Exempt-facility bonds may be issued under the Act to finance solid waste disposal facilities, defined generally as under the prior-law exception for exempt-activity IDBs for solid waste disposal facilities. Thus, tax-exempt financing may be provided for the processing of solid waste or heat into usable form, but not, with exempt-facility bond proceeds, for further processing that converts the resulting materials or heat into other products (*e.g.*, for turbines or electric generators).[76] Congress did not intend the term solid waste to include hazardous waste, including any radioactive waste.[77]

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[72] *See*, items (1)-(4) under the discussion of airport bonds, above.

[73] Mass commuting vehicles are not included in the definition. A separate prior-law exception permitting tax-exempt financing of such vehicles expired after 1984.

[74] *See*, items (1)-(4) under the discussion of airports, above.

[75] *See*, below, for limitations on financing office buildings with the proceeds of exempt-facility bonds generally.

The special rules of prior law, allowing exempt-activity IDB financing for certain qualified steam-generating or alcohol-producing facilities, are repealed.

Facilities for the local furnishing of electric energy or gas

The Act allows exempt-facility bonds to be issued to finance facilities for the local furnishing of electric energy or gas, as defined under the prior-law exception for exempt-activity IDBs for these facilities. Facilities qualifying for such financing generally must serve an area not exceeding two contiguous counties or a city and one contiguous county. Prior-law exceptions under which specified facilities were treated as facilities for the local furnishing of electricity (secs. 644 and 645 of the Deficit Reduction Act of 1984) are retained under the Act.

Local district heating or cooling facilities

Exempt-facility bonds may be issued to finance local district heating or cooling facilities, defined in the same manner as under the prior-law exception for exempt-activity IDBs for this purpose.

Qualified hazardous waste disposal facilities

Under the Act, exempt-facility bonds may be issued to finance qualified hazardous waste disposal facilities. Eligible facilities include facilities for the land incineration[78] or the permanent entombment of hazardous waste, which facilities are subject to final permit requirements under subtitle C of Title II of the Solid Waste Disposal Act, as such subtitle was in effect on October 22, 1986 (the date of enactment of the Act). Tax-exempt financing is available only for facilities (or the portion of a facility) to be used to dispose of hazardous waste generated by the public, as opposed to the owner or operator of the facility or a person related to the owner or operator.[79]

Congress intended that the term hazardous waste not include any radioactive waste. Congress further intended that rules similar to the prior-law rules regarding exempt-activity IDBs for solid waste disposal facilities apply to qualified hazardous waste bonds, including rules limiting hazardous waste to materials having no market or other value at the place at which it is located and rules limiting tax-exempt financing to that portion of a facility which is actually engaged in the incineration or entombment of hazardous waste. (*See, e.g.*, Treas. Reg. sec. 1.103-8(f)(2) and Temp. Treas. Reg. sec. 17.1).

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[76] *See, e.g.*, Temp. Treas. Reg. sec. 17.1.

[77] Congress intended that this clarification provide no inference regarding the treatment of radioactive waste under prior law (*i.e.*, for bonds issued before August 16, 1986). *See*, 132 Cong. Rec. E3392, October 2, 1986 (statement of Mr. Rostenkowski). *See also*, the discussion below of the new category of exempt-facility bonds for qualified hazardous waste disposal facilities.

[78] Congress intended that, for this purpose, the term incineration include equivalent thermal treatment processes subject to final permit requirements under subtitle C of Title II of the Solid Waste Disposal Act (as such subtitle was in effect on October 22, 1986), *e.g.*, supercritical wet-air oxidation.

[79] This requirement is considered satisfied, if 95 percent or more of the net proceeds are to be used with respect to that portion of the facility used to dispose of hazardous waste generated by persons other than the owner or operator of the facility (or a related person).

Qualified residential rental projects

General rules

Under the Act, qualified multifamily residential rental projects, defined in a manner similar to the prior-law rules for exempt-activity IDBs for this purpose, may be financed as exempt facilities. These projects are eligible for tax-exempt financing only if a specified number of housing units in the project is occupied by individuals having low or moderate incomes (determined on a continuing basis)[80] and only if the property remains as rental property for a prescribed qualified project period. In addition, the Act requires operators of these projects to certify annually that the project is in compliance with the set-aside requirement applicable to the project.

Property comprising the exempt facility

Except as described below, qualified residential rental projects generally are to be defined in the same manner as under prior law. Thus, a project is eligible for tax-exempt financing only if the housing units are used on other than a transient basis, and only if each residential rental unit includes separate and complete facilities for living, sleeping, eating, cooking, and sanitation. Hotels, dormitories, hospitals, nursing homes, retirement homes, and trailer parks do not qualify under this exception. (*See, e.g.*, Treas. Reg. sec. 1.103-8(b)(4)(i).)

As under prior law, a project may qualify as an exempt facility even though a portion of the building in which the residential rental units are located is used for a commercial use. No tax-exempt financing may be provided for such nonresidential use portion, however. The costs of such a mixed-use facility must be allocated according to a reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the residential rental units and the nonqualifying property. (*See*, Prop. Treas. Reg. 1.103-(8)(b)(4)(v).)

Required set-aside for low- and moderate-income tenants

In general.—The Act amends the prior law set-aside requirements,[81] permitting qualified residential rental projects to receive exempt-facility bond financing if either—

(1) 40 percent or more[82] of the units in the project are occupied by tenants having incomes of 60 percent or less of the area median gross income (the "40-60 requirement"), or

(2) 20 percent or more of the units are occupied by tenants having incomes of 50 percent or less of the area median gross income (the "20-50 requirement").

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[80] This requirement is referred to as the "set-aside" requirement.

[81] Unlike under prior law, there is no special set-aside requirement for projects located in targeted areas.

[82] For New York City only, 25 percent is substituted for 40 percent.

These set-aside requirements are the same as apply for purposes of the low-income housing credit described in Title II., Part E.2., above. The applicable set-aside requirement for each project must be elected no later than the date on which the bonds are issued. Once made, the election is irrevocable.

As under prior law, the set-aside requirement must be satisfied continuously during a qualified project period. Unlike prior law, however, the determination of whether a tenant qualifies as having low- or moderate-income is made on a continuing basis, rather than only on the date the tenant initially occupies the unit. Increases in a tenant's income may, therefore, result in a unit ceasing to qualify as occupied by a low- or moderate-income person. However, a qualified low- or moderate-income tenant is treated as continuing to be such notwithstanding *de minimis* increases in his or her income.

Under this *de minimis* exception, if a tenant qualifies as having low- or moderate-income when initially occupying a housing unit (or on any subsequent determination date), that tenant is treated as continuing to have such an income as long as his or her family income does not increase to a level more than 40 percent in excess of the maximum income otherwise qualifying as low or moderate income (after adjustment for family size) under the standard applicable to the project. If the tenant's income increases to a level more than 40 percent above the otherwise applicable limit (or if the tenant's family size decreases so that a lower maximum income applies to the tenant), that tenant generally may no longer be counted toward the low- or moderate-income set-aside requirement.

Congress did not intend that tenants be evicted in order to return a project to compliance with the applicable set-aside requirement. Rather, each residential rental unit that becomes vacant while a project is not in compliance with the applicable set-aside requirement must be rented to a low- or moderate-income tenant before any comparably sized or smaller units in the project are rented to tenants not so qualifying, until such time as the project again is in compliance. In general, therefore, the event that gives rise to penalties for noncompliance is rental of a comparably sized or smaller unit (to the unit giving rise to noncompliance) to other than a low- or moderate-income tenant, on other than a temporary basis, during any period for which the project does not comply with the set-aside requirement (or would not comply as a result of the rental of that unit).

The Act clarifies that adjustments for family size are to be made in determining the area median incomes used to qualify tenants as having low or moderate incomes. In general, these adjustments are to parallel those made under section 8 of the United States Housing Act of 1937. Thus, if a project qualifies under the 20-50 requirement, a family of four generally is treated as having a low- or moderate-income if the family has an income of 50 percent or less of the area median gross income; a family of three having an income of 45 percent or less generally qualifies; a family of two having an income of 40 percent or less generally qualifies; and, a single individual having an income of 35 percent or less generally qualifies. (Congress intended that similar 10-percent reductions be made to reflect family size if the 40-60 set-aside requirement is elected.) Congress was aware that the use of rules similar to the section 8 guidelines may result in qualifying incomes above or below the amounts reflected by these percentages because of dollar floors and ceilings that apply under the section 8 program in certain cases.

Special rule for certain rent-skewed projects.—A special rule is provided for certain projects charging significantly lower than market-rate rents to low- and moderate-income tenants. If a project qualifies for this special exception, a tenant who qualifies as having low- or moderate-income upon initially occupying a housing unit (or on any subsequent determination date) is treated as continuing to have such an income as long as his or her family income does not increase to a level more than 70 percent (rather than 40 percent) in excess of the maximum income otherwise qualifying as low or moderate, after adjustment for family size. Additionally, in such projects, in lieu of the requirement (described above) that each available comparable or smaller-sized unit be rented to a tenant qualifying as having low- or moderate-income after a tenant's income has so increased (and until the project is again in compliance), each available low- or moderate-income unit must be rented to a tenant whose income is 40 percent or less of the area median gross income.

To qualify for this special exception, the issuer must elect, no later than the date the bonds are issued, to satisfy a special set-aside requirement. Under the special requirement, a project must have at least 15 percent of its otherwise low- or moderate-income units occupied by tenants having incomes of 40 percent or less of the area median gross income. Thus, for example, in a 100-unit project to which the 20-50 requirement applies, at least 3 units must be occupied by tenants having 40 percent or less of the area median income. This special set-aside, if elected, is to be satisfied together with one of the general set-aside requirements (*i.e.*, the 40-60 or 20-50 requirement); like those requirements, it must be satisfied continuously throughout the qualified project period.

Projects electing this special set-aside requirement also must satisfy two conditions as to the rent charged tenants. First, the gross rent charged to any tenant counted toward the applicable set-aside requirement for the project may not exceed 30 percent of the applicable income limit for that tenant. Second, the gross rent charged to any such tenant may not exceed one-third (33 percent) of the average rent charged to tenants other than low- or moderate-income tenants for units of comparable size. For purposes of these determinations, gross rent is to include the cost of any utilities, other than telephone service. If any utilities (other than telephones) are paid directly by the tenant, the maximum rent that may be paid by the tenant is to be reduced by a utility allowance prescribed by the Secretary, after taking into consideration the procedures under section 8 of the United States Housing Act of 1937. Rental assistance payments made on behalf of the tenant, such as through section 8 of the Housing Act of 1937, are included in gross rent.

Qualified project period.—Bond-financed residential rental projects must remain as rental property and must satisfy the applicable set-aside requirement for the project, throughout a qualified project period. The Act redefines the qualified project period as the period beginning on the date on which at least 10 percent of the units in the project are first occupied (or, if later, the date on which the exempt-facility bonds are issued) and ending on the latest of (1) the date that is 15 years after the date on which at least 50 percent of the units are first occupied; (2) the first date on which no tax-exempt private activity bond used to finance the project remains outstanding; or (3) the date on which any assistance provided with respect to the project under section 8 of the Housing Act of 1937 terminates.

Annual certification of compliance.—Under the Act, operators of bond-financed multifamily residential rental projects must certify compliance with the applicable low- and moderate-income set-aside requirement to the Treasury Department on an annual basis. Congress intended that the Treasury Department may require in the certification such additional data as it deems necessary to monitor compliance with this requirement.

In general, the required certification will be made by operators of projects as agents of the project owners; however, under the Act, project owners are liable for a new penalty in the event of failure on the part of the operators to make complete and timely reports. (Failure to make required reports does not in itself affect the tax status of bond interest.)

Correction of and penalty for noncompliance with set-aside, rental use, and annual certification requirements.—As under prior law, owners and operators of bond-financed residential rental projects must correct any post-issuance noncompliance with the applicable set-aside requirement within a reasonable period after the noncompliance is discovered or reasonably should have been discovered.

The Act provides two penalties for failure to comply with the set-aside and rental use requirements during the qualified project period. First, as under prior law, interest on the bonds used to finance the project becomes taxable, retroactive to the date of their issuance. In addition, failure to correct any noncompliance with the applicable set-aside requirement after it is discovered or reasonably should have been discovered, or termination of use as rental property, results in all interest on bond-financed loans being nondeductible, effective from the first day of the taxable year in which the noncompliance occurred.[83] Interest incurred on bond-financed loans after a project is again in compliance with these requirements is deductible. Interest on the bonds, however, remains taxable (as under prior law).

The Act provides a special penalty for failure to make the required annual certification of compliance with the low- and moderate-income set-aside requirement. This penalty is equal to $100 for each failure to comply and is in lieu of loss of tax-exemption on the bonds or denial of deductions for interest on bond-financed loans. (These consequences may still follow as a result of failure to meet the rental use or set-aside requirements, as described above.) For purposes of applying the penalty, a separate failure to comply occurs each day after the due date that a report is not filed. Likewise, reports with respect to each project owned by one person, or a group of related persons, are separate reports, with any penalty being imposed independently for each such project's required report.

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[83] For a more complete discussion of new rules governing deductibility of interest on bond-financed loans, *see* 8., below, regarding changes in use of property financed with tax-exempt private activity bonds.

Repeal of certain categories of exempt facilities

The Act repeals the prior-law exceptions permitting tax-exemption for interest on bonds to finance sports facilities; convention or trade show facilities; parking facilities;[84] and air or water pollution control facilities.

A transitional exception to the prior-law exception for qualified hydroelectric generating facilities (former sec. 103(b)(4)(H)) is retained under the Act.[85] That transitional exception permits certain hydroelectric generating facilities to continue to be financed through 1988, if an application was docketed by the Federal Energy Regulatory Commission (FERC) by December 31, 1985.[86]

General restrictions on exempt-facility bonds

95-percent use requirement and functionally related and subordinate test

Under the Act, 95 percent of the net proceeds of an issue of exempt-facility bonds must be used to finance the exempt facility for which the bonds are issued and functionally related and subordinate property. Net proceeds are defined as issue proceeds less amounts invested in a reasonably required reserve or replacement fund. No reduction is made for any amounts used to finance any costs of issuance, since those amounts are not treated as spent for the exempt purpose of the borrowing.

As under prior law, property that is functionally related and subordinate to an exempt facility generally may be financed with the proceeds of bonds for such facilities. The definition of functionally related and subordinate property generally is the same as under prior law, except that office space generally is not treated as functionally related and subordinate to an exempt facility.[87] Under the Act, only office space that is *de minimis* in size and cost, that is directly related to the day-to-day operations at an exempt facility, and that is located at or within the facility may be financed as functionally related and subordinate property. Thus, a separate office building, or an office wing of a mixed-use facility, is not treated as functionally related and subordinate to an exempt facility.[88]

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[84] Parking facilities that are functionally related and subordinate to other exempt facilities may continue to be financed with exempt-facility bonds in appropriate cases (*e.g.*, airport public parking facilities).

[85] This prior-law exception generally expired with respect to costs attributable to periods after 1985.

[86] The Act clarifies that an application for a license (rather than a preliminary permit) must have been docketed by FERC, in order for this transitional exception to apply.

[87] The special rules regarding offices financed as part of an airport, dock or wharf, or mass commuting facility (described above) take precedence over these rules with respect to those facilities.

[88] These same principles applied under prior law, and are continued under the Act, as part of the definition of manufacturing facility for purposes of the small-issue bond exception.

As under prior law, exempt-facility bonds are required to satisfy a public use requirement. (*See*, Treas. Reg. sec. 1.103-8(a)(2).)

Governmental ownership requirement for airports, docks and wharves, and mass commuting facilities

The Act requires that all property financed with exempt-facility bonds for airports, docks and wharves, and mass commuting facilities be governmentally owned. Under a special safe-harbor rule, property leased by a government unit is considered to be governmentally owned solely for purposes of this requirement if (1) the nongovernmental lessee makes an election (binding on the lessee and any successors in interest) not to claim depreciation or an investment tax credit with respect to the property, (2) the lease term is not more than 80 percent of the property's reasonably expected economic life, and (3) the lessee has no option to purchase the property at other than fair market value. (Similar rules are to apply in the case of management contracts and other operating agreements.)[89]

Alternatively, governmental tax ownership may be established under general tax rules. These rules provide that the owner of property is required to possess meaningful burdens and benefits of ownership. For example, where property is leased, the lessor has to suffer or benefit from fluctuations in the value of the property, in order to be treated as the owner for tax purposes. Thus, lease treatment may be denied, and the lessee treated as the owner, where (*e.g.*) the lessee has the option to obtain title to the property at the end of the lease term for a price that is nominal in relation to the value of the property at the time the option may be exercised, or for a price that is relatively small compared with total lease payments. A lessee also may be treated as the tax owner in certain situations where the lessor has a contractual right to require the lessee to purchase the property at the end of the lease. In determining tax ownership of property, the form of a transaction is not disregarded simply because tax considerations are a significant motive, as long as the transaction also has a *bona fide* business purpose and the person claiming tax ownership has significant burdens and benefits of ownership. (*See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).)

b. Qualified small-issue bonds

General rules

Under the Act, interest on qualified small-issue bonds is exempt from tax. Small-issue bonds generally are defined in the same manner as small-issue IDBs were under prior law, with the exceptions noted below. As in the case of exempt-facility bonds, 95 percent of the net proceeds of each issue of qualified small issue bonds must be used for the exempt purpose of the borrowing.[90]

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[89] The prior-law rule allowing an exception from the State volume limitations for bonds for certain airport, dock and wharf, and mass commuting facilities, pursuant to which property was treated as governmentally owned if the user made an irrevocable election to forego cost recovery deductions and the investment tax credit, is repealed.

[90] The term net proceeds is defined in the same manner as for exempt-facility bonds.

The Act continues and makes conforming amendments to the $40-million limit on outstanding tax-exempt bonds, applicable to beneficiaries of small-issue bonds.[91] The conforming amendments clarify that all exempt-facility bonds, qualified small-issue bonds, and qualified redevelopment bonds are considered in determining whether the $40-million limit is met or exceeded. Bonds that were exempt-activity IDBs or industrial park IDBs when issued are treated as exempt-facility bonds, and bonds that were small-issue IDBs when issued are treated as small-issue bonds.[92]

The Act clarifies that bonds that are redeemed by a later issue (other than in an advance refunding) are not taken into account for purposes of the limitation. In the case of current refundings (including refundings of bonds originally issued before August 16, 1986) the refunding bonds are not taken into account (even if a beneficiary of the bonds has more than $40 million in bonds outstanding before or as a result of issuance of the refunding bonds) if—

(1) the refunding issue has a weighted average maturity date not later than that of the refunded bonds,

(2) the amount of the refunding issues does not exceed the outstanding amount of the refunded bond,[93]

(3) the interest rate on the refunding issue is lower than the interest rate on the refunded bond, and

(4) the proceeds of the refunding issues are used to redeem the refunded bond not later than 90 days after the date of the issuance of the refunding bond.[94]

Extension of sunset dates

The Act extends the sunset date for qualified small-issue bonds for manufacturing facilities for one year, through December 31, 1989. Under the Act (as under prior law), authority to issue qualified small-issue bonds for non-manufacturing facilities expired on December 31, 1986. Manufacturing facilities are defined in the same manner as under prior law, except bonds for first-time farmers are treated as manufacturing facilities for purposes of the new sunset date. Hence, these bonds also may be issued through 1989.

The Act provides that current refundings of small-issue bonds (including small-issue IDBs) originally issued before the 1986 and 1989 sunsets may be issued after these sunset dates, provided that the refunding bonds—

(1) do not have a weighted average maturity in excess of the weighted average maturity of the refunded issue;

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[91] Beneficiaries of these bonds include all persons (other than governmental units) who are principal users of bond-financed property during a 3-year test period.

[92] Congress did not intend, as a result of the amendments to the tax-exempt bond provisions, that use by a section 501(c)(3) organization during the six-year period for aggregating capital expenditures provided in sec. 144(a)(4) (former sec. 103(b)(6)(D)) for qualifying certain small-issue IDBs for tax-exemption be treated as use by a nonexempt person so as to render that capital expenditures limit violated with respect to bonds issued before August 16, 1986. The same result applies under the $40 million limitation.

[93] Any current refunding issue for an amount in excess of that required to redeem the outstanding principal amount of the refunded bonds (assuming redemption at no greater than par value) counts toward the $40-million limit.

[94] The 90-day limit is reduced to 30 days in the case of refundings of bonds originally issued before August 16, 1986, as under prior law. *See*, Title XVIII..

(2) have a lower interest rate than the rate on the refunded bonds;

(3) are in an amount that does not exceed the outstanding amount[95] of the refunded bonds; and

(4) are used to redeem the refunded bonds not later than 90 days after the date of issuance of the refunding bonds. [96]

(These same conditions apply to qualify for the exemption from the $40-million limitation for certain current refundings, described above.)

First-time farmer exception

The Act modifies several provisions governing issuance of qualified small-issue bonds for agricultural purposes. First, the definition of first-time farmer[97] is expanded to include farmers who would otherwise qualify at the time the financing is provided except that they previously owned land that was disposed of while the farmer was insolvent (within the meaning of Code sec. 108). Second, the Act allows first-time farmers to use up to 25 percent of the maximum $250,000 available under the first-time farmer exception (*i.e.*, a maximum of $62,500) to acquire used agricultural equipment. Additionally, financing for this used equipment is not required to be provided in conjunction with financing for farmland. As under prior law, the $250,000 is a lifetime limit, except that it does not include bond-financed land disregarded under the insolvency exception, above.

Aggregate limit on bond-financed depreciable property used in farming

The Act restricts the aggregate amount of qualified small-issue bond financing for all types of depreciable farm property (including both new and used property) to no more than $250,000 for any person or related persons. Depreciable property financed under the first-time farmer exception counts toward the limitation, as does other depreciable farm property. The $250,000 is a lifetime limit, and includes financing provided before August 16, 1986.[98] For purposes of the limitation, a person is treated as receiving qualified small-issue bond financing for all property of which the person (or a related person) is a principal user, as defined under the small-issue bond exception.

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[95] Any refunding issue for an amount in excess of that necessary to redeem the outstanding principal amount of refunded bonds (assuming redemption at no greater than par value) is not eligible for the exception.

[96] The special limitations on refunding bonds contained in sec. 144(a)(12) apply only to refundings occurring after the otherwise applicable termination date of authority to issue the refunded bonds (original bonds in the case of a series of refundings), *i.e.*, to refundings bonds issued after the applicable sunset date. Congress intended that post-sunset-date refundings of qualified small-issue IDBs originally issued before August 16, 1986, be permitted under limitations identical to those described for refundings of small-issue bonds originally issued after August 15, 1986. (*But see,* Act sec. 1313(a).) A technical amendment may be necessary for the statute to reflect this intent. It further may be necessary to provide in this technical amendment that bonds which were not subject to the new 95-percent-of-net-proceeds requirement of the Act when issued may be refunded under these rules although the refunding bonds do not meet the 95-percent test.

[97] The first-time farmer rule is an exception to the general rule prohibiting the use of exempt-facility and qualified small-issue bonds (previously IDBs) to acquire agricultural land, described in 7.c., below.

[98] Bonds issued before August 16, 1986, count in determining whether later issues exceed the $250,000 limit; however, the tax-exempt status of these earlier issues themselves is not affected.

c. Student loan bonds

The Act continues the tax-exemption for interest on qualified student loan bonds, as defined under prior law. These bonds are bonds issued by qualified governmental units or qualified scholarship funding corporations[99] in connection with the GSL and PLUS programs of the United States Department of Education. These bonds must be both (1) guaranteed by the Department of Education, and (2) eligible for SAP payments (unless such payments are precluded solely by virtue of the tax-exempt status of the bonds).[100] Additionally, the interest charged student borrowers must be restricted as provided in the Higher Education Act of 1965.

The Act also expands the definition of qualified student loan bond to include obligations used to make or finance loans under certain State supplemental student loan programs.[101] Programs qualifying for this financing include any program of general application approved by the State to which part B of title IV of the Higher Education Act of 1965 (relating to Federally guaranteed student loans) does not apply, if loans under the program are limited to the difference between (1) the total cost of attendance and (2) other forms of student assistance for which the student borrowers may be eligible. In measuring other forms of student assistance, loans pursuant to section 428B(a)(1) of the Higher Education Act of 1965 (relating to parent loans), or pursuant to subpart C.I of Title VII of the Public Health Service Act (relating to certain student assistance) for which the student borrowers may be eligible are not taken into account.

Ninety percent of the net proceeds of each issue must be used to make or finance student loans, in the case of bonds issued in connection with the Federal GSL or PLUS programs. This percentage is increased to 95 percent for bonds issued under qualified State supplemental student loan bond programs.[102]

Under the Act, for all tax-exempt student loan bonds, a student borrower must be either (i) a resident of the issuing State, or (ii) enrolled in an educational institution within that State. (If two or more States each use a portion of their volume limitations for a combined issue of student loan bonds, this limitation applies separately to each State's share of the issue.) As under prior law, issuers of bonds in connection with the GSL or PLUS program must make loans available on a nondiscriminatory basis to all individuals attending schools located within the State (without regard to the student's State of residence) and to all residents of the State (without regard to the location within the United States of the schools they attend).

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[99] *See*, note 48, *supra.*, and the accompanying text, for amendments relating to qualified scholarship funding corporations.

[100] Congress intended that student loan bonds that fail to satisfy any of the requirements of Title IV of the Higher Education Act of 1965 (*e.g.*, bonds that receive Federal guarantees, but for which SAP payments are waived) be permitted to be issued as supplemental student loan bonds if the bonds otherwise satisfy all requirements applicable to such bonds. A technical amendment may be necessary for the statute to reflect this intent.

[101] Congress intended that Federal GSL or PLUS student loan bonds and supplemental student loan bonds may be issued as part of a single issue assuming appropriate allocations are made to ensure compliance with, *e.g.*, the different requirements for Federal GSL and PLUS student loan bonds and for supplemental student loan bonds as to "bad money" portions, arbitrage rebate rules, and allowable temporary periods when bond proceeds may be invested without regard to yield restrictions.

[102] Under the Act, a bond may not be treated as a student loan bond if it satisfies the private trade or business use and security interest tests (described in 2., above); however, Congress did not intend this provision to apply to use by section 501(c)(3) organizations solely by reason of their administration of a student loan bond program provided that that activity is not an unrelated trade or business of the organization. A technical amendment may be necessary for the statute to reflect this intent. Such an amendment was included in the versions of H. Con. Res. 395 that passed the House of Representatives and the Senate in the 99th Congress.

d. Mortgage revenue bonds and mortgage credit certificates

Tax-exemption for interest on qualified veterans' mortgage bonds and qualified mortgage bonds[103] is continued under the Act, subject to certain new eligibility and targeting requirements (in the case of qualified mortgage bonds) and new rules regarding the use of bond proceeds. Additionally, the option to exchange authority to issue qualified mortgage bonds for authority to issue mortgage credit certificates is retained, with an increased trade-in rate. Authority to issue qualified mortgage bonds and mortgage credit certificates is extended for one year, through December 31, 1988.

As under prior law, mortgage loans may not be financed with tax-exempt bonds except as specifically provided in section 143 (former sec. 103A) because of the private loan restriction.[104]

Qualified veterans' mortgage bonds

The five States previously authorized to issue qualified veterans' mortgage bonds are permitted to continue issuing such bonds, generally subject to the eligibility and other requirements contained in prior law. These include the existing statewide volume limitations, based on issuance levels between 1981 and June 22, 1984.[105] As is true of other tax-exempt private activity bonds, 95 percent of the net proceeds[106] of each issue of qualified veterans' mortgage bonds must be used for the purpose of the issue (*i.e.*, to make mortgage loans to qualified veterans for the purchase of owner-occupied residences).

The Act clarifies that current refundings of qualified veterans' mortgage bonds are not to be counted toward the State veterans' mortgage bond limits, if the refunding bonds do not exceed the outstanding amount of the refunded bonds.[107] To be exempt from the State veterans' mortgage bond limit, the weighted average maturity of the refunding bonds may be no later than the later of (i) the maturity date of the refunded bonds, or (ii) 32 years from the date of issuance of the refunded bonds (for a series of refundings, the date of issuance of the original bonds in the series). Congress did not intend that current refundings be used as a device for extending the period, generally three years, after issuance of the refunded (original) bonds during which mortgage loans must be made. Thus, this period is measured by reference to the date on which the refunded (original) bonds are issued rather than the date the refunding bonds are issued, and may not exceed three years from the date the refunded (original) bonds were issued.

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[103] These two types of bonds, formerly called mortgage subsidy bonds, are collectively retitled mortgage revenue bonds.

[104] Mortgage loans do not qualify as excluded loans eligible for the tax-assessment bond exception.

[105] Qualified veterans' mortgage bonds are not subject to the new State volume limitations for private activity bonds, discussed in 4., below.

[106] This requirement is identical to the requirement for exempt-facility bonds, described in a, above.

[107] Advance refundings of mortgage revenue bonds are prohibited. A special exception is provided, however, under Act sec. 1863, permitting issuance of up to $300 million of advance refundings of qualified veterans' mortgage bonds, subject to the eligible State's qualified veterans' mortgage bond volume limitation.

Qualified mortgage bonds

The Act continues the exception that permits issuance of qualified mortgage bonds, subject to several amendments to the borrower-eligibility and targeting requirements applicable to such bonds.[108] In general, the amended requirements are similar to the requirements that were in effect before enactment of the Tax Equity and Fiscal Responsibility Act of 1982.[109]

First-time homebuyer requirement

Under the Act, an issue is a qualified mortgage issue only if at least 95 percent of the net proceeds[110] of the issue are used to finance residences for mortgagors who had no present ownership interest in their principal residences during the three-year period before the mortgage is executed (*i.e.*, first-time homebuyers). As under prior law, proceeds used to provide qualified home improvement, qualified rehabilitation loans[111] or to finance residences in targeted areas are not taken into account for purposes of this rule. (A mortgagor's interest in the residence being financed is not taken into account for purposes of the first-time homebuyer requirement.)

Purchase price limitations

The acquisition cost of a residence financed with qualified mortgage bonds may not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to the residence. As under prior law, the determination of average area purchase prices is made separately (1) with respect to new residences and existing, previously occupied residences, and (2) to the extent provided in regulations, with respect to 1-, 2-, 3-, and 4-family residences.

Income limitations

The Act imposes income limitations for recipients of qualified mortgage bond financing. Under these limitations, qualified mortgage bond financing is available only to mortgagors whose family incomes do not exceed 115 percent of the higher of (1) the median family income for the area in which the residence is located, or (2) the Statewide median family income. Family income of mortgagors (as well as median family income) is to be determined by the Treasury Department after taking into account the regulations and procedures under section 8 of the United States Housing Act of 1937. Unlike the rules regarding qualified residential rental projects, no adjustments for family size are made under these income limitations.

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[108] Qualified mortgage bonds are subject to the new State volume limitations for private activity bonds, discussed in 4., below, in lieu of the separate limitations imposed on their issuance under prior law.

[109] The new income limits included in the Act are similar to income limits passed by the House of Representatives during its consideration of the Mortgage Subsidy Bond Tax Act of 1980.

[110] This requirement is identical to the requirement for exempt-facility bonds, described in a., above.

[111] The Act generally conforms the exterior walls requirement in the definition of qualified rehabilitation to the new rules regarding the rehabilitation credit (other than for certified historic structures); however, the amount required to be spent for rehabilitation remains at 25 percent of the mortgagor's adjusted basis, rather than the 100-percent requirement of the rehabilitation credit.

In targeted areas, two-thirds of the mortgage financing provided with the proceeds of each issue must be provided to mortgagors who have family incomes not exceeding 140 percent of the higher of (1) the median family income for the area in which the residence is located, or (2) the Statewide median income. The remaining one-third of the mortgage financing of each issue may be used to provide mortgage loans without regard to income limitations.

Targeted area defined

A targeted area is defined (as under prior law) as (1) a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the Statewide median family income, or (2) an area of chronic economic distress designated by the Secretary of the Treasury and the Secretary of Housing and Urban Development. This definition applies for both purposes of the purchase price limitations applicable to residences financed with qualified mortgage bonds and for purposes of the new income limits.

Special rule for electing limited equity housing cooperatives

The Act provides that limited equity housing cooperatives are eligible, at the election of the cooperative, for tax-exempt financing using the qualified residential rental project targeting and other compliance rules applicable to exempt-facility bonds for such rental property. Limited equity housing cooperatives are cooperative housing corporations (as defined under sec. 216(b)(1)) in which a person is entitled to occupy a dwelling unit by reason of ownership of stock in the cooperative. To qualify for financing as a qualified residential rental project, (1) the cost of any stock in the cooperative must not exceed the amount paid for the stock by the original stockholder (as adjusted for cost-of-living increases),[112] increased by amounts paid for improvements on the stockholder's house or apartment and certain other payments attributable to the stockholder, and (2) the assets of the cooperative in excess of the combined transfer values of outstanding stock in the cooperative (and reduced by any liabilities) must be used only for public or charitable purposes or directly to benefit the cooperative and may not be used directly to benefit any stockholder.

The Act provides that, where a limited equity housing cooperative elects to qualify for tax-exempt financing under the residential rental project targeting and compliance rules, the cooperative's tenant-stockholders will not be entitled to a deduction for their ratable share of interest and taxes paid by the cooperative (under sec. 216). This denial applies throughout the qualified project period as defined for rental housing bond purposes. Bonds issued pursuant to such an election will be treated for most purposes (*e.g.*, the arbitrage rebate requirement, described in 5.b., below) as exempt-facility bonds for residential rental projects. The election to be eligible for financing as residential rental property must be made when the bonds are issued, and once made is irrevocable.

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[112] Congress intended that this cost-of-living adjustment would not be used to avoid the intended effect of the limited equity requirement, *e.g.*, by adjusting the price of cooperative shares to reflect increases in the value of housing not subject to this requirement.

If an election as described above is not made, a limited equity housing cooperative is eligible for qualified mortgage bond financing on the same basis as other owner-occupied housing. Such financing is subject to all the limitations applicable to qualified mortgage bonds (including the first-time homebuyer and purchase price limitations).

Authority to issue bonds for limited equity housing cooperatives (including bonds issued pursuant to the special election described above) expires after December 31, 1988, together with authority to issue qualified mortgage bonds.

Mortgage credit certificates

Qualified governmental units may continue to elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). The trade-in rate for such exchanges is increased from 20 to 25 percent of the exchanged bond authority. Conforming amendments are also made to the MCC provisions to reflect the amendments to the qualified mortgage bond provisions, including the amendments relating to purchase price and income limitations.

The ability to exchange qualified mortgage bond authority for authority to issue MCCs expires for calendar years after 1988.[113]

Annual policy statement requirement

The Act repeals the requirement that issuers of qualified mortgage bonds and mortgage credit certificates annually publish and submit to the Treasury Department statements explaining their policies in issuing such bonds and credits.[114] The present-law information reporting requirements are retained. (*See*, 11., below.)

e. Qualified 501(c)(3) bonds

In general

The Act continues to permit tax-exemption for interest on bonds issued to benefit section 501(c)(3) tax-exempt organizations (*i.e.*, qualified 501(c)(3) bonds). Qualified 501(c)(3) bonds are defined as bonds which would not be private activity bonds if section 501(c)(3) organizations were treated as governmental units with respect to their exempt activities, using a 5 percent of net proceeds standard (rather than the 10 percent of proceeds applicable to governmental bonds) in applying the trade or business business use and security interest tests. Thus, at least 95 percent of the net proceeds[115] of qualified 501(c)(3) bonds must be used by a section 501(c)(3) organization or a governmental unit, and not by other nongovernmental persons. Facilities financed with qualified 501(c)(3) bonds further are required to be owned by a section 501(c)(3) organization, or else by a governmental unit, using general tax concepts of ownership. These provisions apply both to bonds for hospital facilities (discussed further below) and to other qualified 501(c)(3) bonds.

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[113] Congress intended that this sunset date be extended from 1987 to 1988, to parallel the qualified mortgage bond sunset date. A technical amendment may be necessary for the statute to reflect this intent.

[114] Congress intended that this requirement not apply to current refundings issued after August 15, 1986, of bonds originally issued before August 16, 1986. (*But see*, Act sec. 1313(a).) A technical amendment may be necessary for the statute to reflect this intent.

[115] This requirement is identical to the requirement for exempt-facility bonds, described in a., above.

As under prior law, the use of bond proceeds by section 501(c)(3) organizations in unrelated trades or businesses (determined by applying sec. 513(a)) is treated as a nonexempt use. Thus, use of bond proceeds in such an unrelated trade or business (*e.g.*, a laundry facility for multiple hospitals) is allocated to the five-percent bad money portion.

As indicated above, use of more than 5 percent of the net proceeds of the issue by any person other than a section 501(c)(3) organization or a governmental unit causes interest on the issue to be taxable. For example, no more than 5 percent of the net proceeds[116] of a qualified 501(c)(3) issue may be used to finance office space for use by nongovernmental persons in carrying on trades or businesses. An example of such a use would be the use of proceeds of a qualified 501(c)(3) hospital bond to finance an office building for use by physicians in carrying on the private practice of medicine (regardless of whether the ownership or operation of the office building is a related trade or business to that of the section 501(c)(3) organization).[117] Similarly, no more than 5 percent of the net proceeds of these bonds may be used to finance any facilities that are leased to or operated by nongovernmental persons (other than section 501(c)(3) organizations) if the lease or other arrangement satisfies the trade or business use and security interest tests for defining private activity bonds (substituting a 5-percent of net proceeds standard for the usual 10-percent tests).

Certain facilities eligible for financing with qualified 501(c)(3) bonds may comprise part of a larger facility otherwise ineligible for such financing. Conversely, portions of a facility also used in part by a section 501(c)(3) organization may be used for activities of persons other than section 501(c)(3) organizations. Only the portions of such mixed-use facilities owned and used by a section 501(c)(3) organization, and not used by other nongovernmental persons (as described above), may be financed with qualified 501(c)(3) bonds. Congress intended that the Treasury Department may adopt rules for allocating the costs of such mixed-use facilities (including common elements) according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the various users of the facility.

Congress understood that some governmental units issue composite issues, a portion of the proceeds of which is to be used for governmental activities and a portion of which is to be used for section 501(c)(3) organizations operating within the jurisdiction of the issuer. Congress did not intend to preclude continuation of such composite issues provided all applicable requirements for tax-exemption for each type of use concerned are satisfied. Thus, where an issue consists of two components—governmental financing and qualified 501(c)(3) financing—and the two components, viewed as separate issues, satisfy all requirements for tax-exemption as (a) governmental bonds and (b) qualified 501(c)(3) bonds, respectively, a composite tax-exempt issue is permitted, assuming appropriate allocation of such items as costs of issuance, reserve funds, and "bad money" portions between the two components. The portion of the composite issue that is treated as a qualified 501(c)(3) bond is to be treated as such for all purposes, including (but not limited to) the $150-million limitation on non-hospital bonds, the arbitrage rebate requirement, new limits on bond-financed costs of issuance, and the new change in use penalties.

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[116] This five percent is reduced by other so-called "bad money" uses of the issue proceeds.

[117] *See*, Rev. Rul. 77-352, 77-2 C.B. 34, for an example of circumstances under which use of section 501(c)(3) organization facilities by other nongovernmental persons may result in the facilities being treated as used in the other person's trade or business.

Congress further was aware that certain State or local governmental universities and hospitals (including certain public benefit corporations) have received determination letters regarding their tax-exempt status under Code section 501(c)(3). Congress intended that, to the extent that any such entity is a governmental unit or an agency or instrumentality of a governmental unit (determined in the same manner as under prior law), bonds for the entity will continue to be treated as governmental bonds rather than as qualified 501(c)(3) bonds.

$150-million limitation for non-hospital bonds

General rules

Imposition of limitation.—The Act limits the aggregate amount of outstanding qualified 501(c)(3) bonds (other than hospital bonds) from which any section 501(c)(3) organization may benefit to $150 million.[118] Qualified hospital bonds (described below) are not subject to the limitation and are not counted in determining how many bonds are otherwise allocated to a section 501(c)(3) organization. An organization thus may have up to $150 million of bonds outstanding for non-hospital facilities, in addition to any bonds for hospital facilities.

Under this rule, an issue of section 501(c)(3) organization bonds is denied tax-exemption if the aggregate authorized face amount of the issue, when increased by the face amount of all qualified 501(c)(3) bonds (not including qualified hospital bonds) already outstanding and allocated to the organization, exceeds $150 million. In determining whether the $150-million limit has been exceeded, bonds that are redeemed by a later issue (other than in an advance refunding) are not taken into account. In the case of current refundings (including refundings of bonds originally issued before August 16, 1986), the refunding bonds are not taken into account (even though a beneficiary of the bonds has more than $150 million in bonds outstanding before or as a result of the refunding bonds) if—

(1) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds;[119]

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[118] Qualified student loan bonds used to finance student loans to students enrolled in a section 501(c)(3) educational institution are not allocated to the institution for purposes of the limitation.

[119] Any current refunding issue for an amount in excess of that required to redeem the outstanding principal amount of refunded bonds (assuming redemption at no greater than par value) counts toward the $150-million limit.

(2)(a) the weighted average maturity of the refunding issue does not exceed 120 percent of the weighted average reasonably expected economic life of the facilities financed with the refunded issue, or

(2)(b) the last-maturing bond in the refunding issue matures no later than 17 years after the issue date of the refunded bond (for a series of refundings, the issue date of the original bonds in the series); and

(3) the net proceeds of the refunding bond are used to redeem the refunded bond within 90 days of the issuance of the refunding bond (30 days for bonds originally issued before August 16, 1986).

As described above, advance refunding bonds (as well as the bonds they refund) are counted in determining whether the $150-million limit is exceeded. Under a special transitional exception, however, one advance refunding after March 14, 1986, of a bond issued before January 1, 1986, is permitted even if that refunding results in a section 501(c)(3) organization having more than $150 million of outstanding bonds allocated to it. Such advance refunding bonds are counted as outstanding bonds, however, for purposes of determining whether subsequent new money or advance refunding bonds may be issued.

Administration of $150-million limitation.—The $150-million limitation generally is to be administered in a manner similar to the continuing $40-million limitation for beneficiaries of small-issue bonds. For example, bonds generally are to be allocated only among those section 501(c)(3) organizations who are test-period beneficiaries of the bonds in question. Test-period beneficiaries are defined as owners or other principal users of the facilities being financed by the issue at any time during the three-year period beginning on the later of (1) the date such facilities are placed in service, or (2) the date of issue. No portion of an issue generally is allocated to persons other than owners and principal users during this three-year test period.

As under the $40-million limitation, all owners of bond-financed facilities during the three-year test period are allocated that portion of the issue that is equivalent to the portion of the facilities that they own. Additionally, all principal users of the facilities during the three-year test period are allocated a portion of the face amount of the issue equivalent to that portion of the facility used by them. (In certain cases, this may result in all or part of an issue being allocated to more than one section 501(c)(3) organization.)

In determining whether a portion of an issue is allocated to a section 501(c)(3) organization, the related person rules generally applicable to qualified small-issue bonds apply. For example, a university and all related persons (as defined in sec. 267), including related entities engaged in unrelated trades or businesses, are treated as one person in determining whether they are principal users of bond-financed property. A section 501(c)(3) organization also is to be treated as related to any other person if it owns 50 percent or more of either the capital interests or the profit interests in the other. Congress further intended that any section 501(c)(3) organization will be treated as related to any other person if the two have (a) significant common purposes and substantial common membership, or (b) directly or indirectly, substantial common direction. For example, a local chapter of a national organization is related to its national organization. Finally, any section 501(c)(3) organization is related to any other such organization with respect to a particular transaction if such transaction is part of an attempt to avoid the application of this provision of the Act.

Once a portion of an issue is allocated to a section 501(c)(3) organization, that allocation remains in effect as long as the bonds are outstanding. This is true even if the organization no longer owns or uses the property financed with the bonds. Similarly, the fact that persons are no longer related persons after an allocation is made does not alter the allocation to that person as long as the bonds are outstanding.

If an issue of qualified 501(c)(3) bonds causes the $150-million limitation to be exceeded, only the issue that causes the limitation to be exceeded is taxable. However, if the $150-million limitation is violated with respect to an issue by a change of owners or principal users of bond-financed facilities at any time during the three-year test period, the interest on that issue is taxable from the date the bonds were issued.

Treatment of certain pre-August 16, 1986, bonds.—Bonds issued before August 16, 1986, also are allocated to section 501(c)(3) organizations if the bonds were outstanding on that date. Such bonds count toward the $150-million limitation if the bonds were not industrial development bonds under prior law, but would have been had section 501(c)(3) organizations not been treated as exempt persons (*i.e.*, if (i) more than 25 percent of the proceeds were to be used directly or indirectly by a section 501(c)(3) organization or organizations and other nongovernmental persons, and (ii) the prior-law security interest test would have been satisfied with respect to such users). Congress intended that test-period beneficiaries of bonds issued more than three years before August 16, 1986, and that are outstanding on that date, include only the owners and principal users of the bond-financed facilities on August 16, 1986.[120]

For example, if an organization is allocated $100 million in qualified 501(c)(3) bonds as of August 16, 1986, the maximum amount of additional qualified section 501(c)(3) bonds from which the organization may benefit is limited to $50 million, until some or all of the outstanding bonds are redeemed. If an organization is allocated $150 million or more of bonds on August 16, 1986, no additional bonds may be issued until that allocation falls below $150 million following redemption of some or all of the bonds. In no case do these rules affect the tax-exemption of interest on bonds issued prior to August 16, 1986.[121]

Election to benefit from other financing.—The Act permits section 501(c)(3) organizations to elect not to treat bonds for their benefit as qualified 501(c)(3) bonds, and instead to treat such bonds as exempt-facility or qualified redevelopment bonds, provided that all requirements applicable to such other bonds are satisfied and the financing is subject to the new State private activity bond volume limitations. (These bonds would not count toward the $150-million limitation.) For example, a section 501(c)(3) organization may participate in a multifamily residential rental project financed with bonds subject to the applicable State volume limitation by making such an election.

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[120] This determination is different from the determination under the $40-million limit on beneficiaries of small-issue bonds. Under that provision, Treasury Department regulations require actual test-period beneficiaries of pre-effective date bonds to be determined and the bonds allocated accordingly.

[121] The tax-exempt status of bonds issued pursuant to transitional exceptions to this rule similarly is not affected; however, these bonds (like bonds issued before August 16, 1986) are counted in determining how many bonds are allocated to a section 501(c)(3) organization for purposes of evaluating compliance with the requirement at the time later issues are issued.

Exception for qualified hospital bonds

The $150-million limitation does not apply to bonds used to finance hospital facilities. A hospital is a facility that—

(1) is accredited by the Joint Commission on Accreditation of Hospitals (JCAH) or the American Osteopathic Asssociation, or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAH;

(2) is primarily used to provide, by or under the supervision of physicians, to in-patients diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons (including the mentally ill);

(3) has a requirement that every patient be under the care and supervision of a physician; and

(4) provides 24-hour nursing services rendered or supervised by a registered professional nurse, and has a licensed practical nurse or registered nurse on duty at all times.

The term hospital does not include rest or nursing homes, daycare centers, medical school facilities, research laboratories, or ambulatory care facilities (*e.g.*, ambulatory surgicenters).

If an issue is to be used only in part for hospitals, only the portion actually used for hospitals is exempt from the $150-million limit. However, if 95 percent or more of the net proceeds of the issue (90 percent, for pre-August 16, 1986, bonds) are used with respect to a hospital, the entire issue is treated as so used.

Congress was further aware that some bond-financed facilities may be used partially as part of a hospital and partially as a part of a non-hospital, related facility. For example, a laboratory may serve both a hospital and private physicians' offices. Bonds used for such mixed-use facilities may be treated as hospital bonds to the extent of the proportionate share of the use of the facilities for inpatient hospital services (as described above) or to the extent provided pursuant to other allocation formulae prescribed by the Treasury Department.

f. Qualified redevelopment bonds

General rules

The Act permits tax-exemption for the interest on a new category of private-activity bonds, qualified redevelopment bonds. Qualified redevelopment bonds must be part of an issue—

(1) 95 percent or more of the net proceeds[122] of which are to be used for redevelopment purposes in a locally designated blighted area, and

(2) the payment of principal and interest on which is primarily secured either (a) by taxes of general applicability imposed by a general purpose governmental unit, or (b) by a pledge of incremental property tax revenues, which must be reserved exclusively for debt service on the issue and other similar issues, to the extent necessary to cover such debt service.[123] Incremental tax revenues for this purpose means any increased real property tax revenues attributable to increases in assessed value by reason of the redevelopment.

Repayment of qualified redevelopment bonds may *not* be derived from payments from any person other than as described above if such payments would have rendered the bonds IDBs had they been issued under prior law (using a 10-percent use and security interest test).[124] Additionally, as stated above, the pledged tax revenues must be the primary security for repayment of the bonds. Whether such revenues are the primary security is a factual determination. Congress intended that this requirement be satisfied, however, only when the taxes from which repayment of the bonds is to be derived represent a direct and substantial financial commitment by the issuer of the bonds.[125]

Real property taxes imposed in a designated blighted area must be imposed at the same rates and using the same assessment methods as apply to comparable property located elsewhere in the jurisdiction of the designating governmental unit. Additionally, no owner or user of property in the designated area may be subject to a charge or fee, directly or indirectly related to the redevelopment activities, which is not imposed on owners or users of other comparable property in the jurisdiction of the general purpose governmental unit in which the designated blighted area is located. (Insubstantial fees for amenities such as parking are not treated as fees or assessments for this purpose). Where financing is provided with respect to only a portion of a blighted area, these rules apply only to the portion of the area with respect to which financing is provided.

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[122] This requirement is identical to the requirement for exempt-facility bonds, described in a., above.

[123] For this purpose, tax-increment bonds (as defined in sec. 1869(c)(3) of the Act) which were issued before August 16, 1986, are treated as similar issues.

[124] For example, assume that bonds for a redevelopment project are nominally secured by incremental property tax revenues attributable to the redevelopment; however, a nongovernmental person has (1) entered into a special agreement with the city that the redevelopment site will be considered to have an assessed value for local property tax purposes of not less than a prescribed amount, until such time as the bonds are repaid, (2) agreed to be personally liable to pay the difference between the amount of real property taxes levied against the site and the amount of debt service on the bonds, or (3) agreed to finance the cost of credit enhancement for the bonds. Because repayment of the bonds is indirectly secured by payments derived from, or property used in the developer's business, the bonds may not be issued as qualified redevelopment bonds.

[125] Bonds the proceeds of which are used to finance construction and repair of such governmental facilities as street paving, sidewalks, street-lighting, and similar facilities are governmental bonds, and thus are not subject to the new requirements for qualified redevelopment bonds, if the bonds do not violate the trade or business use and security interest tests, the unrelated use restriction, or the private loan restriction, described in 2., above (*i.e.*, if the bonds are not private activity bonds).

Qualified redevelopment bonds may be issued only pursuant to a State law which authorizes the issuance of such bonds to redevelop blighted areas. Additionally, the bonds must be issued pursuant to a redevelopment plan adopted by the governing body of the general purpose local governmental unit having jurisdiction over the designated blighted area, before the issuance of the bonds. For this purpose, general purpose local governmental units are the smallest governmental units having general purpose sovereign powers over a given area.[126] Thus, in most cases, designations of blighted areas will be made by cities or (for areas outside any city) by county governments. The State[127] itself and special purpose governmental units (*e.g.*, a redevelopment authority or agency) are not treated as governmental units entitled to designate blighted areas.[128]

Congress was aware that certain redevelopment agencies adopted redevelopment plans before consideration of the Act, which plans are consistent with the general goals of the Act but which may not meet the specific criteria established by it. Congress did not intend to require redevelopment agencies, which had adopted such redevelopment plans as of August 15, 1986, pursuant to a State law, to resubmit the plan to the general purpose governmental unit having jurisdiction over the designated blighted area. Congress further did not intend to require the agencies to reexamine the original criteria used to designate such blighted areas. However, no new bonds may be issued in such grandfathered areas for activities which may not be financed under the Act with qualified redevelopment bonds. (*See also*, the rules below regarding application of the 20-percent limit on designated blighted areas to such previously designated areas.)

Congress understood that both governmental activities and private activities previously could be financed with a single issue of tax-increment bonds, and intended that the Treasury Department will develop rules for allowing such composite-issue financing to continue by treating the governmental use component and the qualified redevelopment bond component of a single issue as separate issues in appropriate circumstances.

Qualified redevelopment activities

Qualified redevelopment bond proceeds may be used only for specified redevelopment purposes. These purposes are—

(1) to acquire real property located in a designated blighted area, provided that the acquiring governmental unit has the power to exercise eminent domain with respect to such real property;

(2) to clear and prepare land in the designated blighted area for redevelopment;

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[126] This determination is similar to that used for allocating bond authority among overlapping units. *See*, the description of allocations under the State private activity bond volume limitations, in 4.d., below.

[127] Congress was aware that, in the case of the District of Columbia, the city council fulfills roles equivalent to both a State and local government, and intended that the D.C. city council be treated as both a State and local governmental body, as appropriate, for purposes of these requirements.

[128] The State is, however, to establish criteria for designating these areas, consistent with the Federal statutory criteria described below.

(3) to rehabilitate real property acquired as above or otherwise owned by a governmental unit (*e.g.*, property acquired by tax lien foreclosure);[129] or

(4) to relocate occupants of structures on the acquired real property.

Real property acquired by a governmental unit (under (1) above) need not be transferred to a nongovernmental person; however, if it is so transferred, the transfer must be for fair market value. The determination of fair market value for this purpose takes into account covenants and restrictions imposed on the future use of the relevant real property by the issuer of the bonds.

Qualified redevelopment bond proceeds may *not* be used to construct new buildings (including housing) or other property, or to enlarge any existing building. New structures or expansions of existing structures may be financed in redevelopment areas with (1) private, taxable financing, or (2) other private activity bonds, including (a) mortgage revenue bonds, (b) exempt-facility bonds for residential rental housing, or (c) small-issue bonds, in all cases subject to the targeting and other restrictions applicable to these other bonds.

Qualified redevelopment bonds may not be used to finance any activities outside of the designated blighted area with respect to which the bonds are issued.

Characteristics of blighted areas

Criteria for designation

The designation of blighted areas must be based on the substantial presence in the area of factors such as excessive: vacant land on which structures were previously located; abandoned or vacant buildings; substandard structures; vacancies; and delinquencies in the payment of real property taxes.[130]

Maximum area size

The aggregate blighted areas designated by a general purpose local governmental unit may not contain real property, the assessed value of which exceeds 20 percent of the assessed value of all real property located within the jurisdiction of the governmental unit. The percentage with respect to any area is to be determined at the time the area is designated, with these percentages being aggregated for purposes of the 20-percent test. For example, assume that a city designates a redevelopment area in 1987 that contains 10 percent of the assessed value of real property located in the city (determined as of 1987). Assume further that the city designates a second area in 1992 containing 5 percent of the assessed value of all real property in the city (determined as of 1992). If the city wishes to designate a third area in 1997, that area may not contain more than 5 percent of the assessed value of real property in the city, determined as of 1997.[131] Previously designated areas cease to be taken into account, for purposes of the 20-percent test, if no qualified redevelopment bonds (or similar bonds issued under prior law) remain outstanding with respect to the area. Once an area ceases to be counted, the area must be redesignated under the rules of the Act before any further bonds may be issued for redevelopment therein.

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[129] Housing, the rehabilitation of which is financed with qualified redevelopment bonds, need not satisfy the targeting requirements applicable to exempt-facility bonds for residential rental projects or qualified mortgage bonds. As described below, rehabilitation (of housing or other structures) does not include new construction or the expansion of existing buildings.

[130] Existing redevelopment agencies, which had adopted redevelopment plans as of August 15, 1986, pursuant to State law, are not required to reexamine the original criteria used to designate blighted areas; however, no new financing may be provided for activities in these areas which otherwise may not be financed with qualified redevelopment bonds.

Governmental units that had designated blighted areas as of August 15, 1986, in excess of 20 percent of assessed value, and with respect to which qualifying activities were in progress on that date, are not required to reduce those areas to achieve compliance with the 20-percent rule before completing redevelopment activities in those districts. However, no new districts may be designated, or existing districts expanded, until the jurisdiction is in compliance with the 20-percent limit (determined inclusive of those existing districts). Similarly, as stated above, bonds may be issued after August 15, 1986, only for activities for which financing is permitted under the Act.

Minimum area size

A designated blighted area must satisfy one of the following two requirements:

(1) The area must be comprised of at least 100 contiguous and compact acres; or

(2) The area must be comprised of between 10 and 100 contiguous and compact acres, and no more than 25 percent of the bond-financing in the area must be provided to any one person or related persons. The 25-percent rule is not considered to be violated if more than 25 percent of financing is to be made available to one person (or related persons) on an interim basis for use in redevelopment activities if the redeveloped property is to be transferred with reasonable speed in a manner satisfying the 25-percent limitation as part of a unified development plan. This latter determination is to be based on the financing provided pursuant to the overall redevelopment plan for the area, rather than on an issue-by-issue basis.

Congress intended that the designation of blighted areas will be made in contemplation of the redevelopment of the entire designated area, and that the Treasury Department will adopt rules preventing artificial designation of areas in order to allow bond financing for one or a few specific facilities that happen to be located in the area.

Application of certain private activity bond restrictions

Qualified redevelopment bonds generally are subject to all rules applicable to private activity bonds.[132] An exception is provided

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[131] For purposes of determining these percentages, the total assessed value of real property in the jurisdiction includes the assessed value of real property located in previously designated blighted areas (determined as of the date of the subsequent designation).

[132] Qualified redevelopment bonds may be issued in amounts necessary to finance the land that subsequently is transferred to private parties and for the other purposes (*e.g.*, rehabilitation) for which the bonds may be issued, or only for the difference between the cost to the government and the amount paid by private parties for the land—for example, "gap financing". As under prior law, however, bonds are not private activity bonds if property is given or trans-

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from the limitation on use of bond proceeds to acquire nonagricultural land.[133]

No more than 25 percent of qualified redevelopment bond proceeds may be used to finance any facilities, the financing of which is restricted or prohibited with respect to small-issue bonds (new sec. 144(a)(8)) or private activity bonds generally (new sec. 147(e)),[134] or the land on which such facilities are or are to be located. No proceeds of qualified redevelopment bonds may be used to finance any of the following facilities (or land for such facilities):

(1) Private or commercial golf courses;

(2) Country clubs;

(3) Massage parlors, hot tub facilities, or suntan facilities;

(4) Racetracks or other facilities used primarily for gambling; and

(5) Any store the principal business of which is the sale of alcoholic beverages for off-premises consumption.

4. State volume limitations for most private activity bonds

The Act replaces the two separate sets of State volume limitations that applied under prior law to student loan bonds and most IDBs, and to qualified mortgage bonds, with a single private activity bond volume limitation for each State.[135] Qualified veterans' mortgage bonds remain subject to their prior-law State volume limitations.[136]

a. Allowable bond volume

The annual private activity bond volume limitation for each State is equal to the greater of (1) $50 for every individual who is a resident of the State (as determined by the most recent estimate of the State's population released by the Bureau of Census before the beginning of the calendar year to which the limitation applies) or (2) $150 million. For calendar year 1987, and the period August 16,

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ferred for only a nominal amount to private parties, as opposed to being transferred for an amount that satisfies the revised security interest test included in the Act. *See*, 132 Cong. Rec. H8362, September 25, 1986 (statement of Mr. Rostenkowski).

[133] The limitation on use of bond proceeds to acquire existing facilities, unless rehabilitation expenditures equal or exceed 15 percent of the acquisition cost of the facilities, applies to qualified redevelopment bonds. If land and existing structures located thereon are acquired with an intent to demolish the structures, however, all costs of acquiring the property are to be treated as land acquisition costs. (*See also*, sec. 280B.)

[134] These restrictions parallel the facilities the financing of which was restricted or prohibited with respect to small-issue IDBs, or IDBs generally, under prior law.

[135] Congress intended that the Treasury Department will adopt rules to ensure that premiums and discounts are not used for the purpose of avoiding accurate reflection of the true principal amount of an issue. Examples of situations in which these rules may apply include (but are not limited to):

(a) the determination of the face amount of bonds for purposes of the volume limitations on private activity bonds;

(b) the determination of whether the amount of a refunding bond exceeds the outstanding amount of the refunded bond, for purposes of (i) the refunding exceptions to the volume limitation, the $10-million and $40-million limitations applicable to qualified small-issue bonds, and the $150-million-per-institution limitation on nonhospital qualified 501(c)(3) bonds, and (ii) the generic transitional exceptions applicable to refunding bonds (Act sec. 1313); and

(c) the determination of the face amount of bonds for purposes of project-specific transitional exceptions. For example, a refunding issue may violate the requirement under a refunding exception that the refunding issue not exceed the amount of the refunded issue, even though the stated principal amounts of the two issues are the same, if, *e.g.*, the refunding bonds are sold at a premium or are exchanged for refunded bonds that have a fair market value in excess of par.

[136] These limitations are described in 3.d. above, together with the substantive requirements applying to these bonds.

1986, through December 31, 1986,[137] these annual State volume limitations are an amount equal to the greater of (1) $75 per resident of the State or (2) $250 million.

For purposes of these volume limitations, the District of Columbia is treated as a State (and therefore may receive a $250-million volume limitation until 1988, when it will receive a $150-million limitation). U.S. possessions having populations more than that of the least populous State are limited to the $75/$50 per-capita amounts. U.S. possessions having populations less than that of the least populous State receive per-capita volume limitations equal to the per-capita amount actually received by the least populous State (*i.e.*, the $250/$150-million safe-harbor divided by the least populous State's population and multiplied by the possession's population).

b. Bonds subject to the private activity bond volume limitations

Bonds subject to the new State private activity bond volume limitations include most private activity bonds for which tax-exemption is permitted and the private use portion (in excess of $15 million) of governmental issues.[138] Specifically, the volume limitation applies to (1) exempt-facility bonds (other than bonds for airports, docks and wharves, and certain governmentally owned solid waste disposal facilities), (2) qualified mortgage bonds, (3) small-issue bonds, (4) qualified student loan bonds, and (5) qualified redevelopment bonds.[139] Certain other private activity bonds for which tax-exemption specifically is provided in non-Code provisions of the Act also are subject to the new private activity bond volume limitations.[140]

An exception to the requirement that private use of governmental bond proceeds in excess of $15 million be subject to the State volume limitations is provided in the case of use by section 501(c)(3) organizations, if the proceeds used by the section 501(c)(3) organization, treated as a separate issue, satisfy all requirements to be qualified 501(c)(3) bonds. (*See*, 3.e., above, for a description of the new rules permitting composite issues of governmental and qualified 501(c)(3) bonds in certain cases.)

Mortgage credit certificates (MCCs) may continue to be issued by qualified governmental units, provided that the aggregate annual amount of MCCs issued does not exceed 25 percent of the amount of the issuer's private activity bond volume limitation that is exchanged by the issuer.

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[137] Notwithstanding their characterization as private activity bonds for other purposes under the Act, bonds issued before August 16, 1986, are not counted under the new State private activity bond volume limitations for 1986.

[138] The portion of a governmental bond that may be used in a trade or business of a person other than a qualified governmental unit may not exceed 10 percent of net proceeds. Under a special restriction on bonds for output facilities (other than facilities for the furnishing of water), the aggregate bond-financed private use for such facilities may not exceed $15 million; therefore, private use for these facilities will never exceed the amount that renders the private use portion of governmental bonds subject to the new volume limitations (except in the case of certain bonds to advance refund bonds originally issued before September 1, 1986).

[139] Private activity bonds authorized under transitional exceptions to the Act also are subject to these volume limitations unless an exception is provided for these bonds in Act sec. 1315 (providing exceptions to the new volume limitations) or under the specific terms of a project-specific transitional exception.

[140] Bonds issued under the Texas Veterans' Land Bond Program, the Oregon Small-Scale Energy Conservation and Renewable Resource Loan Bond programs, and the Iowa Industrial New Jobs Training Program are subject to the new private activity bond volume limitations.

Consistent with the Act's treatment of advance refunding bonds as additional bonds (since the original bonds are not redeemed within 90 days), advance refundings of governmental bonds are subject to the new private activity bond volume limitations to the extent of any private use of the refunding bonds that exceeds $15 million.[141] Generally, the portion of the proceeds of the refunding bonds attributable to private use will be determined at the time the original bonds are issued. For example, if an investor-owned utility contracts to purchase power from a bond-financed public power facility in declining annual amounts, the percentage of private use determined when the refunded (original) bonds were issued is used in determining the private use portion of the refunding bonds, even though this portion may exceed the amount of actual private use at the time of the refunding. Similarly, in the case of a second advance refunding, this private use portion is determined by reference to the original bond issue (including bonds issued before 1986).

However, if there is a change in facts or circumstances, not originally anticipated at the time of the original issuance, which alters the percentage of private use of the underlying facility, the percentage of private use of the refunding bonds is to take into account the change in circumstances. Thus, for example, if a governmental owner of an output facility sells (or expects to sell) a portion of its ownership interest in the facility to an investor-owned utility (which sale was not anticipated at the time of original issuance), the percentage of private use of refunding bonds issued after such sale must reflect the increased percentage of private use resulting from the sale.

Similar rules apply in the case of advance refundings of only a portion of an outstanding issue, with the added rule that in such a case the governmental and private use portions of the refunded issue generally are allocated proportionately to the portion of the issue being refunded and the nonrefunded portion. For example, assume $75 million of advance refunding bonds are issued to refund 50 percent of a $100-million outstanding issue. Assume further that $25 million of the $100-million issue was attributable to private use when the partially refunded bonds were issued. Twenty-five percent ($18.75 million) of the refunding bonds is treated as attributable to private use for purposes of determining whether an allocation of the issuer's private activity bond volume limitation is required. Congress intended that the Treasury Department will develop appropriate guidelines for treating multiple partial refunding issues as a single issue to prevent avoidance of the requirement that the issuer allocate private activity bond volume limitation to governmental issues having private use in excess of $15 million.

As under the prior-law State volume limitations applicable to IDBs, a State or local governmental unit generally may not allocate its bond authority for facilities to be located outside the State (or the State in which the governmental unit is located).[142] An exception is provided allowing a qualified governmental unit to allocate a portion of its private activity bond volume limitation to financing for facilities located outside the State's boundaries in the case of specified types of facilities, to the extent of the State's share of the use of those facilities. Facilities located outside a State's boundaries to which a portion of its volume limitation may be allocated are (1) facilities for the furnishing of water, (2) sewage disposal facilities, (3) solid waste disposal facilities, and (4) qualified hazardous waste disposal facilities.[143]

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[141] Advance refundings of governmental bonds originally issued before September 1, 1986, are subject to the new volume limitations only if more than 5 percent of the net proceeds of the issue were used for output facilities (not including facilities for the furnishing of water).

In the case of facilities for the furnishing of water and governmental output facilities, the determination of use is based upon the share of the output of the facility received by the State (and its residents). In the case of sewage, solid waste, and hazardous waste disposal facilities, the determination of a State's share of the use of a facility is based on the percentage of the facility's total treatment provided to the State and its residents.[144]

c. Bonds not subject to State private activity bond volume limitations

Qualified 501(c)(3) bonds

Qualified 501(c)(3) bonds are not subject to the new State private activity bond volume limitations. Similarly, the portion of a governmental bond issue used by 501(c)(3) organizations in excess of $15 million (and up to the permitted 10-percent private use portion) is not subject to the new volume limitations. *See also*, the discussion of composite issues of governmental and qualified 501(c)(3) bonds in 3.e., above.

Exempt-facility bonds for airports, docks and wharves and governmentally owned solid waste facilities

Exempt-facility bonds for airports and for docks and wharves are not subject to the new State private activity bond volume limitations. (Under the general rules permitting tax-exempt financing for such facilities, all property financed with such bonds must be governmentally owned.)

Exempt-facility bonds for solid waste disposal facilities are not subject to the new State volume limitations, if all property to be financed with these issues is governmentally owned. Under a special safe-harbor rule, solid waste disposal facilities are treated as governmentally owned for this purpose provided that (1) the term of any nongovernmental lease or service contract (including renewal terms) does not exceed 20 years, (2) the lessee or service contractor has no option to purchase any of the property at any time for other than its fair market value, and (3) the lessee or service contractor irrevocably elects not to claim depreciation deductions (or an investment tax credit under any transition rule) with respect to any property financed with proceeds of the issue. Such an election is binding on any successor in interest to the lessee or service contractor.[145]

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[142] The fact that loans financed with certain student loan bonds generally must be available to all individuals attending schools within the issuing State (regardless of their State of legal residence) and to all residents of the State (regardless of the State in which they attend school) is not affected by the limitation on financing out-of-state facilities, since those bonds are not used to finance facilities. (*See*, 3.c., however, describing a new prohibition on financing loans for students who are enrolled in out-of-state schools and who are not residents of the issuing State.)

[143] Congress intended that volume authority allocations be permitted for the private-use portion of governmentally owned and operated output and other facilities of the type for which out-of-State allocations are permitted in the case of private activity bonds. A technical amendment may be necessary for the statute to reflect this intent.

[144] In the case of governmental facilities, only the private business use portion of bond-financing in excess of $15 million is subject to the new volume limitations. Accordingly, the benefit analysis required for out-of-State allocations is limited to the private use portion of the applicable bond financing and facilities.

Congress intended that the Treasury Department may prescribe rules preventing the use of "front-loaded" rents and other devices to avoid the intended effect of the governmental ownership requirement.

Certain current refunding issues

Certain refunding bonds (other than advance refunding bonds) are not subject to the State volume limitations, provided the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds.[146] In the case of current refundings of student loan bonds, the maturity of the refunding bonds must not exceed the later of (1) the weighted average maturity date of the refunded bonds, or (2) the date that is 17 years after the date on which the refunded obligation was issued (in the case of a series of refundings, the date on which the original issue was issued). This rule is applied in the case of qualified mortgage bonds by substituting 32 years for 17 years.[147] (The maturity of bonds (including refunding bonds) to finance facilities generally is limited to 120 percent of the economic life of the property being financed.)[148]

d. Allocation of private activity bond volume limitation among the State and other qualified governmental units

In general

Each State's private activity bond volume limitation is allocated among the various governmental units within the State that are authorized to issue tax-exempt private activity bonds pursuant to a three-step rule. (This rule is similar to the allocation rules that applied under the prior-law volume limitations applicable to student loan bonds and most IDBs and to qualified mortgage bonds.)

Statutory method.—Under the first step, each State's private activity bond volume limitation is allocated one-half to the State and its agencies having authority to issue tax-exempt private activity bonds, and one-half to local governmental units having authority to issue such bonds. This allocation applies until either the governor or the legislature makes a different allocation, as described below. (Any subsequent allocation for a particular year applies only prospectively and is reduced by bonds issued under the first allocation.)

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[145] Alternatively, the determination of tax ownership may be made using general concepts of tax ownership. *See* 3.a., above, for a description of these rules.

[146] Any current refunding issue for an amount in excess of that required to redeem the outstanding principal amount of the refunded bonds (assuming redemption at no greater than par value) is not eligible for this exception.

[147] For current refundings of student loan bonds and mortgage revenue bonds to be exempt from the volume limitation, the period permitted for making loans to finance student loans or owner-occupied residences must be measured from the date the refunded (or original) bonds were issued. *See, Effective Dates*, below, for a more detailed description of this requirement.

[148] The term refunding includes a rollover of commercial paper and other comparable actions which, under prior (and present) law, constitutes a reissuance of so-called flexible bonds. *See*, 131 Cong. Rec. H12461, December 17, 1985 (colloquy between Mr. Rostenkowski and Mr. Matsui).

The allocation to local governmental units having authority to issue bonds is made on the basis of the relative populations of those units. The population estimates to be used in allocating each governmental unit's volume limitation are the most recent population estimates from the Bureau of the Census released before the beginning of the calendar year to which the determination relates. When a determination involves comparison of the population of two or more governmental units, data for the same year must be used.

Where two or more local governmental units overlap, the volume limitation is allocated first to the governmental unit with jurisdiction over the smallest geographical area. The volume limitation for that jurisdiction is determined by multiplying the one-half of the State limitation allocated to issuers other than the State by a fraction, the numerator of which is the most recent population estimate of that governmental unit and the denominator of which is the population estimate of the entire State, using that same data. The remaining portion allocable to the governmental unit with jurisdiction over the larger area is equal to one-half of the State's unified volume limitation multiplied by a fraction the numerator of which is the population of the larger governmental unit not residing in the smaller governmental unit and the denominator of which is the population of the entire State.[149]

Where two governmental units have authority to issue bonds for nongovernmental persons and both governmental units have jurisdiction over an identical geographical area, the portion of the State volume limitation allocable to that area is allocated to the governmental unit having the broader sovereign powers. For example, where a city and an industrial development authority for the city (that is itself a governmental unit) both are authorized to issue private activity bonds, then the portion of the State ceiling allocable to the city based upon the population of that city is allocated to the city since the city has broader sovereign powers.

Gubernatorial proclamations.—Under the second step, the governor of each State is provided authority, during an interim period, to allocate the State's private activity bond volume limitation among any of the governmental units and other issuing authorities (both State and local) having authority to issue bonds subject to the limitation. This power of the governor to allocate the State limitation, and any allocation rules established by the governor, terminate after the last day of the first calendar year after 1986 during which the legislature of the State meets in regular session. Such authority and allocation rules terminate earlier than this date if overriding State legislation having an earlier effective date is enacted. In the case of a State (North Carolina) in which the governor does not have the veto power and in which any such proclamation is subject to legislative review when issued, Congress intended that the governor's proclamation be treated as legislation, unless specifically overridden by action of the State legislature.

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[149] A governmental unit may voluntarily transfer all or part of its allocation to the unit having jurisdiction over the next largest geographic area.

State legislation.—Under the third step, the State legislature may enact a law providing a different allocation than that provided in steps one or two. Pursuant to this authority, the State legislature may allocate all or any portion of the State private activity bond volume limitation to any local governmental units or other issuing authorities (both State and local) that have authority to issue bonds subject to the limitation.

Congress intended that a State be permitted to allocate available private activity bond volume authority to an issuer until a specified date during each year (*e.g.*, November 1) at which time the authority, if unused, reverts to the State for reallocation. Similarly, a State statute may provide discretionary authority to a public official (*e.g.*, the governor) to allocate the State's volume limitation. Because the private activity bond volume limitation is an annual amount, however, any authority that has not been used for bonds issued before the end of the calendar year expires (unless a special carryforward election, discussed below, is made).

Congress intended that gubernatorial proclamations issued at any time before October 22, 1986, or State legislation enacted before that date, be recognized for purposes of allocating the new State volume limitations, provided that the proclamation or legislation refers to the new private activity bond volume limitation.[150] Bonds issued before such gubernatorial proclamation or (if earlier) before State legislation may not be denied use of a prior allocation of the new private activity bond volume limitation to the extent of the bond authority the issuer would have received based on population (*i.e.*, pursuant to step one).

The rule of prior law, under which public officials were required to certify that volume limitation allocations were not made in consideration of a bribe, gift, gratuity, or campaign contribution, does not apply to allocations under the new State private activity bond volume limitations.

Special rule for constitutional home rule cities

The Act provides a special allocation rule for certain political subdivisions with home rule powers under a State constitution. The home rule subdivisions to which the special allocation rule applies are those home rule subdivisions that are granted home rule powers by the beginning of the calendar year in which the bonds are issued pursuant to a State constitution that was adopted in 1970 and became effective on July 1, 1971 (*i.e.*, Illinois). In that State, a full portion of the State volume limitation is allocated to each home rule subdivision based upon the ratio that the population of that home rule subdivision bears to the population of the entire State. As is true of the other private activity bond volume limitation determinations, this allocation is made using the most recent population estimate from the Bureau of the Census released before the beginning of the calendar year to which the bonds relate. The amount so allocated to home rule subdivisions may not be altered by the power to provide a different allocation otherwise granted to the governor or the State legislature. However, a home rule subdivision may agree to a different allocation.

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[150] For example, a gubernatorial proclamation that refers to the "unified volume limitation contained in H.R. 3838, as passed by the House of Representatives, or any modification of that limitation enacted as part of tax reform legislation included in a conference report on H.R. 3838" is to be treated as satisfying this requirement.

The portion of the State's private activity bond volume limitation not allocated to constitutional home rule subdivisions then is allocated among the other governmental units in the State having authority to issue bonds subject to the volume limitation under essentially the same three steps described in the previous section. Thus, under the first step, one-half of the remaining State limitation is allocated to the State and its agencies. The other one-half of the remaining State limitation is allocated to the localities outside of the home rule subdivisions, based upon the ratio that the population of each of those localities outside of home rule subdivisions bears to the population of the State's residents located outside of such subdivisions. Under the second and third steps described above, the governor or the State legislature may allocate the State's bond volume limitation to any governmental units that have authority to issue bonds subject to the limitation (including the home rule subdivisions), but may not so allocate any amount specially reserved for the home rule subdivisions.

For purposes of the rules regarding State action in allocating the private activity bond volume limitation, a mayor of a constitutional home rule city is treated as a governor, and a city council is treated as a State legislature.

e. Three-year carryforward

An issuer may elect to carry forward any portion of its private activity bond volume limitation for up to three years for certain purposes. When such an election is made, bonds issued in the three calendar years following the calendar year for which the election is made are not counted towards the State's private activity bond volume limitation in the year of issuance to the extent that the proceeds of the bonds are used for the purpose for which the election was made. The bond authority specified in carryforward elections is absorbed in order of the calendar years in which the authority arose. A carryforward election, once made, is irrevocable.

The election to carry forward unused State volume limitation is to be made in the manner provided in the Treasury Department regulations. The election may not be made for projects to be financed with qualified small-issue bonds or for the private use portion of governmental bonds.

For purposes of this election, identification of the type of exempt-facility bonds to be issued, *e.g.*, bonds for sewage facilities or water-furnishing facilities, is to be deemed sufficient. The purpose of issuing student loan bonds, of issuing qualified mortgage bonds or mortgage credit certificates, or of issuing qualified redevelopment bonds, is also to be considered a separate purpose that is adequately specified for purposes of the carryforward election. Carryforwards of authority to issue qualified mortgage bonds and mortgage credit certificates may be made only for bonds actually issued in calendar years before 1989, or credits issued with respect to exchanged bond authority for such years, because of the scheduled expiration of authority to issue these bonds after 1988.

Except as specifically provided above, no part of any State's bond volume limitation may be carried forward to any portion of a succeeding year.[151] Similarly, a State may not borrow against future volume limitations.

5. Arbitrage restrictions

The Act makes various amendments to the general arbitrage restrictions applicable to all tax-exempt bonds; extends to all tax-exempt bonds a requirement that certain arbitrage profits be rebated to the Federal Government; extends to all private activity bonds (except qualified 501(c)(3) bonds) a limitation on the amount of bond proceeds that may be invested in higher-yielding nonpurpose obligations; and makes other arbitrage-related changes.

a. General arbitrage restrictions applicable to all tax-exempt bonds

Profit limitations

Subsequent intentional acts to create arbitrage

The Act codifies the "reasonable expectations" test of prior law with respect to subsequent deliberate and intentional acts to earn impermissible arbitrage taken subsequent to issuance of the bonds. Under the Act (as under prior law), the determination of whether bonds are arbitrage bonds generally is based upon the reasonable expectations of the issuer on the date of issue. If such subsequent acts are taken after the date of issue to earn arbitrage, however, the reasonable expectations test does not prevent the bonds from being taxable arbitrage bonds. (*See, e.g.*, Rev. Rul. 80-91, 1980-1 C.B. 29; Rev. Rul. 80-92, 1980-1 C.B. 31; and Rev. Rul. 80-188, 1980-2 C.B. 47.)

For purposes of this continuing requirement, any investment with respect to which impermissible arbitrage earnings accrue may result in the interest on the issue becoming taxable, retroactive to the date the issue was issued. For example, if after the expiration of an allowable temporary period, the issuer continues to invest the bond proceeds at a materially higher yield in order to earn impermissible arbitrage, interest on the bonds is taxable. Congress intended that the determination of whether deliberate and intentional actions to earn arbitrage have been taken be made on a case-by-case basis, taking into account all facts and circumstances that a prudent investor would consider in determining whether to invest bond proceeds.

Repeal of election to forego temporary periods

The Act repeals the right to elect (under Treasury Department regulations) to forego a temporary period during which unlimited arbitrage earnings are permitted, and by doing so to receive the right to earn arbitrage of 0.5 percentage points (plus certain costs where appropriate) over the yield of the issue. Thus, the definition of the term materially higher generally is limited to the amount otherwise provided in Treasury regulations (generally, 0.125 percentage points over the yield on the issue for acquired purpose and acquired nonpurpose obligations),[152] regardless of whether temporary periods during which unlimited arbitrage earnings are permitted are claimed.

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[151] Carryforwards of prior-law 1986 bond volume authority are prohibited under the Act.

Expansion of investments subject to yield restriction

The Act further restricts the types of property in which bond proceeds may be invested without regard to yield restrictions.[153] Under the Act, the arbitrage restrictions are expanded to apply to the acquisition of any property held for investment other than another bond exempt from tax under section 103. Thus, investment in any taxable security as well as any deferred payment contract (*e.g.*, an annuity) or any other property held for investment is precluded if the yield on the investment property is materially higher than the yield on the issue. This restriction applies regardless of the purpose of the investment (*i.e.*, whether the investment is acquired as an acquired purpose obligation, an acquired nonpurpose obligation, or an acquired program obligation).

Under this rule, for example, the purchase of an annuity contract to fund a pension plan of a qualified governmental unit is subject to the same arbitrage restrictions as direct funding of that plan with bond proceeds.[154] Similarly, investment of bond proceeds in any other type of deferred investment-type contract to fund an obligation of the issuer or a beneficiary of the bonds also is subject to arbitrage restrictions. These restrictions do not apply, however, to real or tangible personal property acquired with bond proceeds for reasons other than investment (*e.g.*, a courthouse or other public facilities financed with bond proceeds). Congress intended this provision to prohibit issuance of refunding bonds (as well as new issues) of pension arbitrage bonds after September 25, 1985, regardless of whether the proceeds of the refunded bonds used to acquire the annuities may have been treated as spent proceeds under prior law or under certain project-specific transitional exceptions included in the Act.[155]

Treatment of certain credit enhancement fees

The Act retains the prior-law rule under which bond insurance premiums are treated as interest expense for purposes of the Code arbitrage restrictions if the bond insurance results in a reduction in the interest rate on the issue. The Treasury Department further is directed to amend its regulations to permit the same treatment for the costs of certain other credit enhancement devices (*e.g.*, letter of credit fees). Thus, if the purchase of a letter of credit results in a net present-value interest savings, the fee is to be treated as if it were interest expense under the arbitrage restrictions. (*See*, Treas. Reg. sec. 1.103-13(c)(8).)

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[152] In the case of acquired program obligations, the prior-law limit of 1.5 percentage points (plus certain costs) permitted by Treasury Department regulations also is not affected.

[153] Section 648 of the Deficit Reduction Act of 1984 provides that, in certain cases, property held in a Permanent University Fund for two specified universities is not treated as an investment of bond proceeds for purposes of the Code arbitrage restrictions. The Act does not affect this provision.

[154] Congress was aware that bond proceeds might be used to prepay items as a means to avoid arbitrage restrictions, and intended for the Treasury Department to adopt rules to treat such prepayments as investment-type property where appropriate. This treatment was not intended to apply, *e.g.*, to customary prepayments for bond insurance.

[155] A technical amendment may be necessary for the statute to reflect this intent.

The treatment of credit enhancement fees as interest for purposes of the arbitrage yield calculation is limited to fees that arise from an arm's-length transaction and that represent a reasonable charge for transfer of credit risk. Thus, Congress understood that the Treasury Department may restrict this treatment to credit enhancement devices purchased pursuant to competitive bidding by credit enhancement providers, or may otherwise appropriately restrict the provision to prevent deflection of arbitrage through devices such as arrangements for multiple services between the issuer and the credit enhancement provider. Congress further intended that if a credit enhancement fee or premium is increased to reflect indirect payment of additional costs of issuance (*i.e.*, costs in addition to a charge for transfer of credit risk), the entire fee or premium is not to be treated as interest expense.

Exceptions to profit limitations

Temporary period rules for pooled financings

The Act imposes new restrictions on temporary periods during which unlimited arbitrage earnings are permitted in the case of pooled financings. Under these restrictions, net proceeds to be used to make loans, but which have not been used to make loans within 6 months of the date of issue, may not be invested at an unrestricted yield after such 6-month period, until the proceeds have actually been used to make loans. In the case of amounts representing repayments (or sales) of loans from a pool, the 6-month period is reduced to 3 months.

These limitations on pooled financings do not extend the maximum temporary periods allowed under Treasury Department regulations in the case of pooled financings, but rather are limitations on those temporary periods. Thus if, as under prior law, proceeds of a pooled financing are to be used to make construction loans, the aggregate temporary period allowed to the pool and the borrowers generally may not exceed three years (a maximum of six months to the pool and a maximum of 30 additional months to the borrower). Similarly, in the case of pooled financings for tax and revenue anticipation loan financing, the aggregate temporary period to the pool and the borrower may not exceed 13 months.

Whether a financing constitutes a pool is a factual determination. In general, however, the term pooled financing only includes issues the proceeds of which are to be used to make loans, as opposed to issues to finance a specific project that will be jointly owned by more than one entity.

The statutory temporary period rules for pooled financings do not apply to mortgage revenue bonds, since the substantive rules for qualified mortgage bonds require, in certain cases, that proceeds not be expended until after expiration of one year and the initial temporary period for these bonds is limited to one year (in certain cases, 18 months).[156] Additionally, in the case of qualified student loan bonds issued in connection with the Federal Guaranteed Student Loan (GSL) and Parents' Loans for Undergraduate Students (PLUS) programs, 18 months is substituted for six months (for bonds issued before January 1, 1989, only). Tax-exempt student loan bonds other than bonds issued before 1989 in connection with these two Federal programs are subject to the six-month period provided generally for pooled financings.[157]

Minor portion exception

The Act limits the minor portion of bond proceeds which may be invested at an unrestricted yield to an amount not exceeding the lesser of five percent of the proceeds of the issue or $100,000. This minor portion is in addition to the exception for amounts invested in a reasonably required reserve or replacement fund (described below).[158]

Reasonably required reserve fund exception

The Act limits the amount of proceeds from the sale of the bonds[159] that may be invested in a reserve or replacement fund to an amount not exceeding 10 percent of the proceeds of the issue, unless the Treasury Department determines that a larger amount is necessary with respect to an issue.[160] Congress intended, however, that a reserve or replacement fund in excess of 10 percent be allowed without the necessity of a Treasury determination with respect to the specific issue if the master legal document authorizing issuance of the bonds (*i.e.*, a master indenture) was adopted before August 16, 1986, and the indenture—

(1) requires a reserve or replacement fund in excess of 10 percent of proceeds, but not more than maximum annual debt service;

(2) is not amended after August 31, 1986; and

(3) provides that bonds having a parity of security may not be issued by or on behalf of the issuer for the purposes provided under

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[156] *See*, Temp. Treas. Reg. sec. 6a.103A-2.

[157] Bonds that receive a Federal guarantee under the GSL program, but which do not meet the other requirements of sec. 144(b)(1)(4), are not eligible for this special exception. *See*, the description of the new rules applicable to student loan bonds, above.

[158] As under prior law, in a refunding issue, the minor portion exception applies only to transferred proceeds that originally were proceeds of a nonrefunding issue.

[159] Congress intended that the Treasury Department adopt rules to prevent avoidance of this and other restrictions through artificial allocations (or replacements) of bond proceeds. For example, it was not intended that the restrictions on bond-financed issuance costs could be avoided by using unexpended proceeds of a prior issue to pay issuance costs of a refunding issue.

[160] Congress understood that in certain cases where bonds are repaid from a tax of general application, which tax is levied by the voters of a governmental unit specifically for the purpose of paying debt service in conjunction with the unit's issuance of bonds, State law may be interpreted to preclude the governmental unit from using those taxes (or income derived from investments of the taxes pending payment of debt service) for any purpose other than payment of debt service while such "tax bonds" are outstanding. In such cases, the governmental unit's inability to predict precisely the extent to which there will be nonpayments or a delay in payment of taxes may lead to the establishment of a tax rate which results in tax collections in any given year exceeding the debt service on its bonds during that year. These circumstances may, in turn, result in an accumulation of taxes and investment income in a fund dedicated to repayment of the bonds. Congress intended that the Treasury Department will adopt rules that will treat such excess amounts as part of a reasonably required reserve or replacement fund. This treatment does not, however, increase the maximum amount that may be invested in a reserve fund for any bond issue or the maximum amount that may be invested without regard to yield restrictions. Additionally, amounts treated as a reserve fund pursuant to such rules are subject to the rebate requirement applicable generally to gross proceeds invested as part of a reserve fund.

the indenture without satisfying such reserve fund requirements of the indenture.[161]

Congress understood that issuers may, in certain cases, pledge additional amounts as part of a reserve or replacement fund, which amounts are derived other than from sale of the issue, but which are treated for purposes of the arbitrage restrictions as bond proceeds. *See*, *e.g.*, Treasury regulation sec. 1.103-14(d)(4) and (5) regarding circumstances in which certain pledged endowment funds are treated as amounts invested in a reasonably required reserve or replacement fund. The 10-percent limitation on the amount of bond proceeds that may be invested in a reserve or replacement fund applies only to amounts of proceeds from the sale of an issue that are invested in such a fund, and not to these other amounts. Thus, these other amounts may continue to form part of a reserve or replacement fund (in addition to amounts of actual bond proceeds forming part of such a fund) even if they cause the fund to exceed the 10-percent limitation.[162]

The Act continues the prior-law rule that amounts of proceeds invested in a reasonably required reserve or replacement fund (up to the new 10-percent maximum, as described above) are not subject to the arbitrage yield restrictions, and does not affect the prior-law exceptions contained in Treasury regulations (Treas. Reg. sec. 1.103-14(d)).[163]

Determination of bond yield

The Act provides that, for purposes of all arbitrage restrictions applicable to tax-exempt bonds, the yield on an issue is to be determined based on the issue price, taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (secs. 1273 and 1274). Thus, yield is determined on the basis of the price at which a substantial amount of the bonds of each maturity comprising the issue are sold to the public and must reflect a current market price. This amendment reverses the holding in the case *State of Washington v. Commissioner, supra.*[164]

b. Additional arbitrage restrictions applicable to certain bonds

The Act extends to all tax-exempt bonds, other than mortgage revenue bonds, a rebate requirement similar to that previously applicable to most IDBs. (Mortgage revenue bonds are subject to a separate rebate requirement.) Additionally, a limitation on investment in higher-yielding nonpurpose investments, similar to that previously applied to IDBs and qualified mortgage bonds, is extended to all private activity bonds other than qualified 501(c)(3) bonds. These restrictions, where applicable, are in addition to the general arbitrage restrictions for all tax-exempt bonds.[165]

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[161] *See*, 132 Cong. Rec. E3392 (October 2, 1986) (statement of Mr. Rostenkowski).

[162] Arbitrage profits on such additional amounts are subject to the rebate requirements of the Act and prior law (where appropriate) to the same extent as other proceeds of the issue.

[163] As under prior law, amounts invested in a reserve or replacement fund are not treated as having been spent for the governmental purpose of the borrowing; thus under the Act, any arbitrage profits on such a fund must be rebated to the Federal Government. *See*, the discussion of the arbitrage rebate requirements, below.

[164] This definition of yield does not affect the ability to treat certain credit enhancement fees as interest costs under the arbitrage restrictions, as discussed above.

Rebate requirement for all tax-exempt bonds (other than mortgage revenue bonds)

General rules

As previously was required of most IDBs, certain arbitrage profits earned on nonpurpose investments acquired with the gross proceeds of any tax-exempt bond must be rebated to the United States. Nonpurpose investments include all obligations other than those specifically acquired to carry out the governmental purpose for which the bonds are issued. Obligations invested in a debt service reserve fund or in an escrow established with the proceeds of a refunding issue are considered to be nonpurpose investments.

Gross proceeds are the total proceeds of an issue, including the original proceeds of the bonds, the investment return on obligations acquired with the bond proceeds (including repayment of principal), and amounts to be used or to be available to pay debt service on the issue. Congress intended that the term gross proceeds be interpreted broadly, as under the prior-law additional IDB restrictions.

Arbitrage profits that must be rebated include (1) the excess of the aggregate amount earned on all nonpurpose investments (other than income earned on the arbitrage itself) over the amount that would have been earned if all nonpurpose investments were invested at a yield equal to the yield on the issue, plus (2) any income earned on that arbitrage. The yield on the issue is determined based on the price at which a substantial amount of the bonds of each maturity are sold to the public, taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (secs. 1273 and 1274). *See*, the revised rules for determining issue price under the general arbitrage restrictions.

Costs associated with nonpurpose investments or with the bond issue itself (including issuance costs and underwriter's discount) are not considered. Additionally, gain or loss realized on the disposition of any nonpurpose investments (assuming a disposition at fair market value) is included in determining the aggregate amount earned on such investments. The deflection of arbitrage through the purchase or sale of nonpurpose investments at other than fair market value is prohibited.[165a]

Congress was aware that qualified governmental units frequently commingle bond proceeds with tax and other revenues during temporary periods when unlimited arbitrage on the bonds is permitted.

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[165] The term refunding includes rollovers of commercial paper and other comparable actions which, under prior (and present) law, constitute a reissuance of so-called flexible bonds. *See*, 131 Cong. Rec. H12461, December 17, 1985 (colloquy between Mr. Rostenkowski and Mr. Matsui).

[165a] Congress understood that Treasury Department regulations with respect to IDBs provide that the purchase or sale of a certificate of deposit (CD) does not result in a prohibited payment for rebate purposes if, *inter alia*, the price paid is the same as would be paid on an active secondary market in such CD's (or comparable obligations). Because of State-law requirements, political subdivisions in some States generally have invested proceeds of bonds other than private activity bonds in CD's for which no secondary market exists. Congress intended that the investment of such governmental bond proceeds in bank CD's generally will not result in a prohibited payment if, for example, the issuer receives *bona fide* bids from three or more unrelated financial institutions and purchases a CD at the bank offering the highest yield.

This commingling differs from practices used in connection with most financing for nongovernmental persons. In general, the rebate requirement of the Act requires separate accounting for bond proceeds, since issuers must rebate arbitrage profits regardless of whether the bond proceeds are commingled with other amounts. Congress intends, however, that the Treasury Department may prescribe simplified methods of accounting for governmental bond proceeds in cases involving commingling of bond proceeds, or in any other cases where such simplified methods are appropriate.[166]

Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being due no later than 60 days after retirement of the issue. Congress intended, however, that to the extent provided in Treasury Department regulations, a series of issues which are retired during the same 6-month period may be treated as one issue solely for the purpose of timing of rebate payments. This special rule applies only if none of the bonds for which the combined rebate payments are made (i) has a maturity of greater than 60 days or (ii) is a private activity bond.[167]

Congress intended that the Treasury Department will develop rules that, in appropriate circumstances, allow qualified governmental units to establish annual computation dates for all governmental bond issues issued by them, rather than being required to compute rebate payments on a different date for each issue. This exception is to apply only with respect to the intermediate five-year (*i.e.*, 90-percent) rebate payment due dates, and not the final payment due date following retirement of the bonds. Additionally, any such exception provided by Treasury is not to apply to any private activity bonds.

Congress further intended that the Treasury Department may modify the requirement that rebate payments be made at 5-year intervals in the case of advance refunding bond proceeds placed in escrow accounts. Such escrow accounts may involve investments at differing yields over the term of the bonds which in the aggregate comply with the arbitrage yield restrictions. This situation is distinguished from non-escrow funds or regular variable rate debt, since the yield on the issue to maturity is determined with certainty when the escrow account is established. Thus, the Treasury Department may determine that, in appropriate circumstances, rebate payments with respect to advance refunding escrow proceeds are not required until the escrow is paid out.

Congress was aware that there may be rebatable arbitrage profits with respect to a particular issue during one five-year period followed by a negative arbitrage posture during the next five-year period, or *vice versa*. The requirement that only 90 percent of the arbitrage profits be rebated with a final "settling up" after retirement of the bonds reflects the Congress's understanding that exact determinations might not be possible during earlier periods. Therefore, subsequent rebate payments (including, but not limited to, payments made after retirement of the bonds) are to reflect overpayments and underpayments during previous periods.

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[166] This is separate from the rebate exception for certain small governmental issues, discussed below.

[167] A technical amendment may be necessary for the statute to reflect this intent. Such an amendment was included in the versions of H. Con. Res. 395 which passed both the House of Representatives and the Senate in the 99th Congress. A further technical amendment may be necessary for the statute to reflect Congress' intent that this rule be self-implementing and authorizing Treasury to extend this rule to other circumstances involving a series of issues. Congress intended that any rules issued pursuant to this direction may involve only the timing of rebate payments as opposed to the amount ultimately required to be rebated by an issuer.

The amount subject to rebate is not taxable and the rebated amount is not deductible for Federal income tax purposes.

Exceptions to rebate requirement

The Act retains, and extends to all tax-exempt bonds, the prior-law exception under which the rebate requirement does not apply if all gross proceeds of an issue are expended within six months of the issue date for the governmental purpose for which the bonds are issued. As under prior law, amounts invested as part of a reserve or replacement fund are not treated as spent for the governmental purpose of the borrowing. Similarly, as under prior law, redemption of bonds within the 6-month period is not treated as an expenditure of bond proceeds for the governmental purpose of the borrowing. (A special exception for certain *de minimis* unspent portions is provided in the case of governmental bonds, as described below.)

In the case of bonds issued as part of a series, only one six-month period is allowed; that period begins on the date on which the first bonds in the series are issued. Similarly, only one six-month period is available with respect to a single issue of bonds where more than one draw-down of proceeds is anticipated or occurs. Application of the six-month expenditure requirement to pooled financings, including bond banks, is determined by reference to the period beginning on the date the bonds are issued by the bond bank and ending on the date when the gross proceeds of the issue are spent for the ultimate exempt purpose of the borrowing (rather than the date on which the bond bank lends the bond proceeds).

Also as under prior law, a second exception is provided for certain temporary investments related to debt service. Under this exception, if less than $100,000 is earned on a bona fide debt service fund in a bond year with respect to an issue, arbitrage profits earned on the fund in that year are not subject to the rebate requirement, unless the issuer elects to consider such amount when determining the amount of the rebate otherwise due with respect to the issue. This election must be made at the time of, or before, issuance of the bonds, and the election, once made, is irrevocable.

The Act provides three additional exceptions to the rebate requirement. First, no rebate is required with respect to bonds (other than private activity bonds) issued by a governmental unit having general taxing powers, if (i) 95 percent or more of the net proceeds of the issue are to be used for local governmental activities of the issuing governmental unit (or of a governmental unit entirely within the jurisdiction of the issuing governmental unit), and (ii) the governmental unit reasonably expects to issue no more than $5 million in bonds (other than private activity bonds) during the calendar year in which the issuance occurs.[168] In determining whether the $5-million limit is reasonably expected to be exceeded, all bonds other than private activity bonds[169] issued by or on behalf of the issuing governmental unit and all other entities that are subordinate to it under applicable State or local law are counted. A governmental unit may be subordinate to any issuer if, for example, its budget is subject to control by the issuer. The performance of purely ministerial functions such as attesting to the legality of a bond issue, however, would not by itself create a subordinate relationship. Private activity bonds issued by or on behalf of the issuing governmental unit or subordinate entities are not counted toward the $5-million limit and are not eligible for this exception from the rebate requirement.

A second exception is provided for governmental bonds[170] and qualified 501(c)(3) bonds if all but a *de minimis* portion of the gross proceeds of an issue are spent for the exempt purpose of the borrowing within six months after the date of issuance. Under this exception, if the gross proceeds of an issue, other than an amount not exceeding the lesser of five percent or $100,000 of the gross proceeds, are spent within six months after the date of issue, the Act permits an additional six months to spend the remaining *de minimis* portion of the proceeds before rebate payments are required. For purposes of this exception, unlike the general rules for the rebate requirement, redemption of this allowable *de minimis* portion of proceeds before expiration of the additional six-month period is treated as an expenditure for the purpose of the borrowing.

Third, the Act provides a transitional exception from the rebate requirement for certain qualified student loan bonds issued in connection with the Federal GSL and PLUS programs. This transitional exception applies only with respect to bonds issued before January 1, 1989, and is designed to allow issuers of qualified student loan bonds issued in conjunction with these two Federal programs to continue to issue bonds while they find other sources of revenue to defray administrative costs (*e.g.*, program costs) and costs of issuance. (Typically, other revenue sources such as direct Federal funding or funding from State or local governments have not been provided for these purposes in the past.)

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[168] Congress intended that, where (i) a governmental unit having general taxing powers borrows from a bond bank (including a similar arrangement) which bank exclusively lends bond proceeds in a manner that does not result its bonds being private activity bonds, (ii) the use of the proceeds by each borrower from the bank would not result in those proceeds being private activity bonds (if viewed as a separate issue), and (iii) issues (other than private activity issues) by the borrowing governmental unit and subordinate entities (including borrowings from the bond bank and other sources) are not reasonably expected to exceed $5 million for the calendar year, the small-issuer rebate exception is to be available to the borrowing governmental unit with respect to the borrowings from the bond bank. In applying the rebate rule to nonpurpose investments acquired by other borrowers with proceeds of the bonds issued by the bond bank (*i.e.*, those issuers directly or indirectly issuing more than $5 million of governmental bonds during the calendar year), the yield on the bonds, rather than the yield on loans to the borrower from the bond bank, is to be used in computing the amount of rebate. (As under the general rule on expenditures for the governmental purpose of the borrowing, the making of a loan by the bond bank is not an expenditure for purposes of the 6-month expenditure rebate exception; thus, the bond bank and its borrowers are subject to rebate unless all proceeds of the issue are expended for the ultimate purposes of the borrowing within that period or, in the case of governmental units borrowing from the bank, the unit qualifies under the small-issuer rebate exception.)

[169] In making this determination, bonds issued before September 1, 1986, are counted.

[170] This exception does not apply to so-called tax and revenue anticipation notes (TRANs); rather, a special safe-harbor exception from the rebate requirement, described below, is provided for those governmental bonds.

Under this exception, the rebate requirement does not apply to gross proceeds earned during the initial 18-month temporary period permitted for such bonds if—

(1) the gross proceeds are used to pay costs of issuance financed with the bonds; or

(2) the gross proceeds are used to pay administrative costs of the student loan program attributable to such issue and the costs of carrying such issue, but only if the proceeds of the issue are used to make or finance qualified student loans before the end of the 18-month temporary period permitted under the Act. The exception does not apply if the issuer so elects.

Arbitrage profits may not be used to pay either costs of issuance or administrative costs, under the exception, to the extent that those costs are to be reimbursed by borrowers (other than through interest payments at rates generally established by the U.S. Department of Education for GSL and PLUS bonds).

As with the special exception to the new temporary period rules, described above (*i.e.*, an initial 18-month temporary period rather than the six months permitted for pooled financings generally), this exception does not apply to tax-exempt student loan bonds other than bonds issued before January 1, 1989, in connection with the Federal GSL and PLUS programs.[171]

Rebate safe-harbor for certain governmental financings

As described above, arbitrage profits on all tax-exempt bonds, including tax and revenue anticipation notes (TRANs) issued to fund cash-flow shortfalls of governmental units, generally must be rebated to the Federal Government if all gross proceeds of an issue are not spent for the exempt purpose of the borrowing within six months of the date of issuance. For purposes of this general rule, TRAN proceeds are deemed to be spent as the cash-flow deficits for which the notes are issued occur and the note proceeds are used to offset these deficits. The Act provides a special safe-harbor exception for TRANs pursuant to which all gross proceeds are deemed to have been spent for the exempt purpose of the borrowing within six months.[172]

Under this safe-harbor exception, if during the six-month period after issuance the cumulative cash-flow deficit of the governmental unit using the TRAN proceeds has exceeded 90 percent of the face amount of the issue, all net proceeds and earnings thereon of the TRAN issue are deemed to have been spent for the purpose of the borrowing. Solely for the purposes of this safe-harbor, cumulative cash-flow deficit is defined as the excess of the amount the governmental unit spends during the relevant period over the sum of all amounts (other than the issue proceeds) that are available for payment of the expenses during that period.[173] As under the general rules regarding arbitrage rebate, redemption of bonds is not treated as an expenditure for the purpose of the borrowing.[174]

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[171] As noted in the description of the new rules applicable to student loan bonds, above, bonds that receive a Federal guarantee under the GSL program but which do not meet the other requirements of sec. 144(b)(1)(A) are not eligible for this special exception.

[172] In addition to this safe-harbor exception, TRANs may qualify for a rebate exception if the governmental issuer establishes that it has actually spent the proceeds of the notes for governmental purposes within six months of their issue. For this purpose, as described above, TRAN proceeds are treated as spent only as actual cash-flow deficits arise and the note proceeds are used to offset these deficits. Proceeds held on hand in governmental treasuries at the end of a determination period and expenditures occurring when other funds are available are not treated as made from TRAN proceeds. (*See*, 132 Cong. Rec. S13960 (September 27, 1986) (colloquy between Senator Moynihan and Senator Packwood); 136 Cong. Rec. E3391 (October 2, 1986) (statement of Mr. Rostenkowski).)

Limitation on loss of tax-exemption for certain rebate errors

The Act provides a special penalty, in lieu of loss of tax exemption, for certain failures to rebate arbitrage profits in the case of governmental bonds and qualified 501(c)(3) bonds. Under the Act, the Treasury Department is authorized to waive loss of tax-exemption on an issue where an error in the amount rebated or a late payment occurs, if the error or late payment is not due to willful neglect.[175] In such cases, a penalty equal to 50 percent of the amount not properly paid is imposed. Interest accrues on these late payments and underpayments, and on the applicable penalty, in the same manner as on late payments of tax. The penalty and interest may, however, be waived by the Treasury Department.

Rebate requirement for mortgage revenue bonds

The Act retains the provisions of prior law that require either crediting of certain arbitrage profits on qualified mortgage bonds to mortgagors or rebate of those earnings to the Federal Government. In addition, the Act extends these provisions to qualified veterans' mortgage bonds. These rules apply in lieu of the rebate requirements applied to other tax-exempt bonds (as described above). Qualified mortgage bonds and qualified veterans' mortgage bonds also are subject to a restriction on investment in nonpurpose investments (described below), similar to that which previously applied to qualified mortgage bonds.

Additional restrictions on student loan bonds

The Act retains the 1984 direction to the Treasury Department to develop regulations imposing additional arbitrage restrictions on tax-exempt student loan bonds, to the extent that that direction is not inconsistent with specific provisions of the Act applicable to student loan bonds. As under prior law, new regulations issued pursuant to the 1984 direction are to be effective not earlier than six months after the regulations are proposed.

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[173] Congress intended that, for purposes of the rebate requirement, the Treasury Department will adopt rules that provide that deficits are treated as occurring only if no amounts other than bond proceeds are available to the governmental units to pay the expenses for which bond proceeds are to be used. In determining whether an amount is available to a governmental unit, these rules may provide that the fact that the amount is deposited in special purpose accounts or otherwise earmarked is to be disregarded if the governmental unit using the TRAN proceeds either (i) established the restrictions on the use of the other funds, or (ii) has the power to alter the use of the other fund. *But see,* Treas. reg. sec. 1.103-14(c)(3).

[174] This safe-harbor does not affect the amount of TRANs that may be issued by a governmental unit or that qualify for a temporary period exception from arbitrage yield restrictions.

[175] A technical amendment may be necessary for the statute to reflect Congress' intent that the standard for waiver is the absence of willful neglect (rather than reasonable cause).

Restriction on investment in nonpurpose investments for private activity bonds (other than qualified 501(c)(3) bonds

In addition to the rebate requirement, the Act extends to all private activity bonds, other than qualified 501(c)(3) bonds, a limitation on the amount of bond proceeds that may be invested in nonpurpose investments. (Such a limitation previously applied to qualified mortgage bonds and most IDBs.) Under the Act, the amount of proceeds that may be so invested at a yield above the bond yield at any time during a bond year is limited to 150 percent of the debt service for the bond year. These investments must be reduced as the bond issue is repaid. This restriction does not apply to amounts invested for an initial temporary period during which unlimited arbitrage profits may be earned and for temporary periods related to current debt service. (The rebate requirement does apply, however, to such amounts if the gross proceeds (including, *e.g.*, amounts invested as part of a reserve or replacement fund) are not expended for the governmental purpose of the borrowing within six months and none of the other exceptions to that requirement is applicable.)

For purposes of this restriction, debt service includes interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but does not include payments with respect to bonds that are retired before the beginning of the bond year. This restriction does not, however, require the sale or other disposition of any investment if that disposition would result in a loss that exceeds the amount that otherwise would be paid to the United States assuming a payment was due at that time.

c. Modification of SLGS program

Under the Act, notwithstanding any other provision of law or any regulation issued pursuant to such a provision, the Treasury Department is directed to extend its State and Local Government Series (SLGS) program to allow more flexible investment of bond proceeds in a manner eliminating the need for rebating arbitrage profits on tax-exempt bonds. Specifically, the Treasury Department is directed to permit demand deposits by eliminating advance notice and minimum maturity requirements relating to the purchase of SLGS. (The Treasury also is to offer time deposits for a period specified by the purchaser, as under prior law, subject to reasonable advance notice requirements.) All obligations issued as part of the revised SLGS program are to be available in the same manner as secondary market transactions (*i.e.*, for next day settlement unless forward settlement is specified).

Congress intended that the revised program will operate in a manner similar to a privately managed mutual fund. Congress further intended that the revised SLGS program will operate at no net cost to the Federal Government. Thus, the Treasury Department is authorized to charge appropriate fees and/or establish interest rates on SLGS such that the difference between any investments of the bond proceeds and the rate paid thereon are sufficient (together with any fees charged) to defray costs of operating the program. Congress anticipated that the maximum interest rate on SLGS will reflect an after-tax cost of borrowing on taxable Federal obligations of a comparable maturity, adjusted to cover operation costs.

Finally, Congress was aware that the Treasury Department had rigidly applied many requirements under the prior-law SLGS program. For example, if SLGS were not purchased on the date specified in the application, Treasury barred the issuer from investing in SLGS for six months. Congress intended that the Treasury Department will apply its regulations under the revised program (both as to demand and time deposits) in the most flexible manner possible, in light of Congress's intent in adopting this provision. For example, if inability to settle on a specified date is due to reasonable cause, a delayed closing date, without penalty, should be permitted.

6. Restrictions on advance refundings

Under the Act, no private activity bonds other than qualified 501(c)(3) bonds may be advance refunded.[176] An advance refunding is any refunding where all of the refunded bonds are not redeemed (*i.e.*, called in such a manner that no further interest accrues on the bonds) within 90 days after the refunding bonds are issued. For refunding bonds issued before January 1, 1986, 180 days is substituted for 90 days.

When permitted, advance refundings are subject to the following restrictions:

(1) Issues that originally were issued before January 1, 1986, may be advance refunded a total of two times. All advance refunding issues that were issued before January 1, 1986, or that are issued on or after that date, are counted in determining whether the two-times limit has been reached. (A special transitional exception permits bonds issued before January 1, 1986, that had been advance refunded two or more times before March 15, 1986, to be advance refunded one additional time after March 14, 1986.)

(2) Issues that originally were issued after December 31, 1985, may be advance refunded once.

(3) In the case of advance refundings where it is possible for the refunding to produce a present-value debt service savings (determined without regard to issuance and administrative costs)[177]—

(a) if the refunded bonds were issued before January 1, 1986, the refunded bonds must be redeemed no later than the first date (occurring more than 90 days after issuance of the refunding bonds) on which they could be redeemed at a premium of 3 percent or less; and

(b) if the refunded bonds are issued after December 31, 1985, the refunded bonds must be redeemed no later than the first date (occurring more than 90 days after issuance of the refunding bonds) on which their redemption is not prohibited.[178]

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[176] Bonds that may not be currently refunded as a result of any provision of the Act or of prior law (*e.g.*, the 1984 Act), or that could not be advance refunded under prior law, may not be advance refunded under this provision. Similarly, bonds authorized for certain specified State programs, pursuant to non-Code provisions of the Act, are private activity bonds and may not be advance refunded.

[177] These requirements were intended to apply, *inter alia*, to any crossover refunding of a floating- or fixed-rate issue and to any other advance refunding that does not result in the defeasance of the prior issue. If two or more prior issues are refunded by a single issue, and the refunding of one or more prior issue may produce a present-value debt service savings, that issue or issues must satisfy the applicable call requirements. If such a refunding may produce a present-value debt service savings in the aggregate, all of the refunded issues must satisfy the applicable call requirements.

(4) New restrictions on initial temporary periods[179] when unlimited arbitrage earnings are permitted apply to both the refunded and refunding bonds:

(a) the initial temporary period for advance refunding bonds is limited to 30 days; and

(b) the initial temporary period for refunded bonds terminates no later than the date the advance refunding bonds are issued.[180]

(5) The permitted minor portion claimed with respect to the refunded issue, which may be invested without regard to arbitrage yield restrictions, must be reduced to an amount no greater than that permitted generally under the Act for new issues (*i.e.*, the lesser of 5 percent of the issue proceeds or $100,000 per issue, not including amounts invested during an allowable temporary period or as part of a reasonably required reserve or replacement fund for the refunded issue).[181]

(6) As described more fully under the section on the new private activity bond volume limitations, proceeds of an advance refunding issue generally are subject to those new State volume limitations to the same extent as if the refunding issue were an original issue.

In addition to items (1)-(6) above, any advance refunding that involves the use of a "device" to obtain a material financial advantage (based on arbitrage) other than savings arising from lower interest rates is prohibited. Thus, the use of such a device in connection with the issuance of advance refunding bonds (*i.e.*, any so-called flip-flop or other device described in the examples below, or any other device described in Treasury Department regulations or rulings)[182] results in interest on the advance refunding bonds being taxable from the date of their issue. This prohibition is similar to the "artifice or device" provision under prior law (*see*, Treas. Reg. sec. 1.103-13(j)), except that it does not require a specific finding that the transaction or series of transactions increases the burden on the market for tax-exempt bonds.

The following examples describe some of the types of transactions that are to be treated as devices for purposes of this provision:[183]

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[178] Additionally, Congress intended that Treasury may provide rules to prevent any attempt to evade the first call date requirement through artificial means, *e.g.*, by extending the call protection of the refunded bonds.

[179] The 30-day temporary period rule applies only to proceeds to be used to redeem the refunded bonds. Thus, special temporary period rules for amounts used to pay accrued interest, issuance costs, and certain *de minimis* amounts provided in Treasury Department regulations are unaffected by the Act. (*See*, Treas. Reg. sec. 1.103-14(e)(3)(vii), (viii), and (ix).)

[180] This rule applies whether or not the refunded bonds were issued on or after September 1, 1986.

[181] Congress did not intend, however, for this rule to preclude a second advance refunding (where permitted under the Act), when because of escrow terms in effect before January 1, 1986, that may not be amended, the minor portion for the first advance refunding legally may not be reduced. In such cases, Congress anticipated that the Treasury Department may permit issues to adjust down the yield of the proceeds of the prior issue by investing the proceeds of the refunding issue at a lower yield.

[182] Congress intended that, in most circumstances, Treasury will exercise its authority under sec. 7805(b) to make such regulations or rulings prospective in effect. Congress did not intend, however, to limit the authority of the Treasury Department to apply such regulations or rulings retroactively where the device involves a deliberate and intentional effort to earn economic arbitrage in connection with the issuance of advance refunding bonds.

[183] No inference was intended that transactions described (or not described) in these examples did not render interest on bonds taxable under prior law.

Example (1).—Pursuant to a transaction or series of transactions in connection with the issuance of advance refunding bonds, proceeds of the refunding bonds are allocated to amounts used to pay debt service on the refunded bonds which, absent the refunding, would have been paid with proceeds (other than proceeds in a reasonably required reserve fund) of the prior issue. Assume, for example, that proceeds of the refunding bonds are allocated to amounts used to pay the next installment of debt service on the refunded bonds. Absent the refunding, the next installment of debt service would have been paid with revenues accumulated on or before the date of issue of the refunding bonds (or capitalized interest on the refunded bonds). The method of allocation adopted by the issuer permits the issuer to allocate the revenues to amounts used to pay a later installment of debt service on the refunded bonds and to invest the revenues and the earnings thereon substantially longer than they would have been invested absent the refunding. The allocation method is a device in that it enables the issuer to obtain a material financial advantage that would not have been available if proceeds of the refunding bonds had not been allocated to amounts used to pay debt service which otherwise would have been paid with the prior issue proceeds.

Example (2).—Pursuant to a transaction or series of transactions, bonds are issued to pay costs which were to be paid with proceeds of a prior issue, and the proceeds of the prior issue are invested in an escrow established to pay debt service on the prior issue (or any other issue) payable in future years. The proceeds of the prior issue are invested at a materially higher yield than the yield on the bonds, or the issuer otherwise secures a material financial advantage from this replacement. Bonds issued pursuant to this transaction or series of transactions are treated as advance refunding bonds for purposes of the additional restrictions on advance refundings under the bill, and the issuer is considered to have employed a device in connection with the issuance of the refunding bonds to obtain a material financial advantage apart from savings attributable to lower interest rates.

Example (3).—A direct monetary benefit with respect to the refunded bond is achieved by reason of issuance of an advance refunding bond and is not taken into account in determining the yield on the refunding bond. For example, if an advance refunding enables the issuer to obtain a rebate of a portion of the premium paid to insure the prior issue (or results in a reduction in the interest payable on the prior issue and thus a reduction in the amount of refunding bonds needed to refund the prior issue), the issuer will be considered to have employed a device in connection with the issuance of the refunding bond to obtain a material financial advantage apart from savings attributable to lower interest rates unless the yield on the refunding bond is determined by taking the direct monetary benefit into account (*i.e.*, as an increase in the issue price of the refunding bond).

Example (4).—Pursuant to a series of transactions, a prior issue is refunded by issuing (1) long-term advance refunding bonds (intended to be tax-exempt) to pay debt service on the prior issue in the early years, and (2) short-term advance refunding bonds (not intended to be tax-exempt) to pay debt service on the prior issue in the later years. Proceeds of the short-term (taxable) advance refunding issue are invested at a yield materially higher than the yield on both the short-term and the long-term advance refunding issues, or the issuer otherwise secures a material financial advantage based on arbitrage by separating the two issues. By separating the two issues, the issuer has attempted to exploit the difference between the taxable rate at which proceeds of the short-term advance refunding issue are invested and the tax-exempt rate of the long-term advance refunding issue. If a material financial advantage has been obtained by separating the two issues, the issuer has employed a device in connection with the issuance of the long-term advance refunding bonds to obtain a material financial advantage apart from savings attributable to lower interest rates.

In adopting the device rule, Congress did not intend to restrict, on a *per se* basis, so-called "low-to-high" advance refundings occurring (i) to obtain relief from specific covenants included in the refunded bonds or (ii) to restructure debt service, provided that these advance refundings do not additionally involve a device as described above or in Treasury regulations or rulings issued pursuant to this provision.

7. Miscellaneous restrictions applicable to private activity bonds

Prior law imposed various rules establishing criteria and standards with respect to specified types of tax-exempt bonds. The Act modifies certain of these rules, and extends several of them to all (or most) private activity bonds; it also imposes certain new restrictions.

a. Limitation on bond-financing of issuance costs

As described in the discussion of each category of private activity bonds, above, the Act requires that at least 95 percent of the net proceeds of private activity bond issues be used for the exempt purpose of the borrowing.[184] Net proceeds is defined as the proceeds of the issue minus amounts invested as part of a reasonably required reserve or replacement fund. Thus, amounts used to pay any costs of issuance must be paid from the so-called five-percent "bad money" portion of an issue.

The Act additionally specifically restricts the amount of private activity bond (including qualified 501(c)(3) bond) proceeds that may be used to finance most costs of issuance to two percent[185] of the face amount of the issue. This percentage is increased to 3.5 percent in the case of issues of mortgage revenue bonds the aggregate authorized face amount of which does not exceed $20 million.

Costs of issuance subject to the two-percent (3.5 percent) limit include all costs incurred in connection with the borrowing—in general, all costs that are treated as costs of issuing or carrying bonds under existing Treasury Department regulations and rulings. Examples of costs of issuance that are subject to the two-percent limitation include (but are not limited to)—

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[184] This percentage is reduced to 90 percent in the case of qualified student loan bonds issued in connection with the Federal GSL and PLUS programs.

[185] The fact that proceeds in excess of two percent were used to finance costs of issuance of refunded bonds issued before the effective date of this provision does not preclude issuance of refunding bonds where otherwise permitted under the Act.

(1) underwriters' spread (whether realized directly or derived through purchase of the bonds at a discount below the price at which they are expected to be sold to the public);

(2) counsel fees (including bond counsel, underwriter's counsel, issuer's counsel, company counsel in the case of borrowings such as those for exempt facilities, as well as any other specialized counsel fees incurred in connection with the borrowing);

(3) financial advisor fees incurred in connection with the borrowing;

(4) rating agency fees;

(5) trustee fees incurred in connection with the borrowing;

(6) paying agent and certifying and authenticating agent fees related to issuance of the bonds;

(7) accountant fees (*e.g.*, accountant verifications in the case of advance refundings) related to issuance of the bonds;

(8) printing costs (for the bonds and of preliminary and final offering materials);

(9) costs incurred in connection with the required public approval process (*e.g.*, publication costs for public notices generally and costs of the public hearing or voter referendum); and

(10) costs of engineering and feasibility studies necessary to the issuance of the bonds (as opposed to such studies related solely to completion of the project, and not to the financing).

As described above, bond insurance premiums and certain credit enhancement fees may be treated as interest expense under the arbitrage restrictions. To the extent of their treatment as interest, the cost of these types of costs of issuance may be financed in addition to the two-percent (3.5-percent) limit on financing other costs of issuance.

b. Restriction on term to maturity

The Act extends the prior-law rule under which the term of IDBs could not exceed 120 percent of the weighted average economic life of the property financed to all private activity bonds (including qualified 501(c)(3) bonds), other than mortgage revenue bonds and student loan bonds. For purposes of this rule, land financed with bond proceeds is treated as having an economic life of 30 years (as opposed to 50 years under prior law).

A special rule is provided in the case of qualified 501(c)(3) bonds 95 percent or more of the proceeds of which are used for pooled financings for two or more section 501(c)(3) organizations (or governmental units), and which meet certain other requirements. For qualifying issues, the maximum permitted maturity for an issue is determined by reference to each loan to a participant in the pool. For example, if a pool participant borrows funds for property having a 10-year ADR midpoint life, the maximum loan term permitted to that participant is 12 years. (If the participant borrowed funds for more than one property, a weighted average economic life would be used as under the 120-percent limit generally.)

An exception to the 120-percent limit also is provided for issues 95 percent or more of the net proceeds of which are to be used to finance mortgage loans to section 501(c)(3) hospitals that are insured under FHA 242 or a similar Federal Housing Administration program (as such programs were in effect on the date of enactment of the Act) where the loan term approved by FHA and the maximum maturity of debentures which could be issued by FHA in satisfaction of its insurance obligation exceed the maximum term otherwise permitted.

c. Restriction on bond-financing of land and existing property

The prior-law restrictions on the use of IDB proceeds to acquire land and existing property are applied to exempt-facility and small-issue bonds. The existing property restriction, and the restriction on acquiring agricultural land, are applied to qualified redevelopment bonds; however, the restriction on acquiring nonagricultural land does not apply to these bonds.[186] Prior-law exceptions to these restrictions are retained; these include the first-time farmer exception and the exception to the existing property rule if rehabilitation expenditures equal or exceed 15 percent of bond-financed acquisition costs.[187]

d. Substantial user restriction

The prior-law rule, under which interest on IDBs is taxable during any period when the bonds are held by a substantial user of the bond-financed facilities (or a related party), is applied to exempt-facility, small-issue, and qualified redevelopment bonds.

e. Restriction on bond-financing of certain specified facilities

The Act extends the prior-law rules, under which interest on IDBs is not tax-exempt if the bonds are to be used to provide specified types of facilities, to all private activity bonds, other than qualified redevelopment bonds.[188] Facilities the financing of which is prohibited under this rule include, *inter alia*, airplanes, skyboxes or other private luxury boxes, health club facilities, facilities used primarily for gambling, and any store the principal business of which is the sale of alcoholic beverages for consumption off premises. The prohibition on financing health clubs does not apply to qualified 501(c)(3) bonds if the health club facility is directly used for the purpose qualifying the section 501(c)(3) organization for tax exemption.

Additional prior-law restrictions on the use of small-issue IDB proceeds continue to apply to qualified small-issue bonds.

f. Public hearing and approval or voter referendum requirement

The prior-law public approval requirements for IDBs are extended to all private activity bonds. As was provided when this requirement was enacted in 1982, a public hearing and approval (or voter referendum) is not required for issues exclusively to refund

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[186] If land and existing structures are acquired with an intent to demolish the structures, all costs of acquiring the property are treated as land acquisition costs.

[187] Amendments to the first-time farmer exception are described above, in the discussion of rules applicable to small-issue bonds.

[188] Qualified redevelopment bonds are subject to special rules regarding facilities for which financing is restricted or prohibited. *See*, the discussion of rules applicable to these bonds in 3.f, above.

(other than to advance refund) a prior issue, provided issuance of the refunded issue was approved by the appropriate elected official following such a hearing (or by voter referendum). This exception does not apply, however, in the case of refunding bonds that will mature after the maturity date of the refunded bonds.[189]

Congress recognized that the prior-law IDB public approval requirements required identification of specific facilities. (*See*, Temp. Treas. Reg. sec. 5f. 103-2.) In extending this requirement to all private activity bonds, Congress intended that the applicable Treasury regulations will be amended for student loan bonds (where no facilities are financed), mortgage revenue bonds (where the exact residences to be financed may not be identified before issuance of the bonds), and qualified 501(c)(3) bonds that qualify for the special exception to the maturity limitation for pooled financings (where the facilities need not be identified before issuance of the bonds).

The Act continues the ability of qualified scholarship funding corporations to issue tax-exempt student loan bonds in conjunction with the Federal GSL and PLUS programs. Congress recognized that, in some cases, these corporations are neither governmental units nor "on behalf of" organizations, and intended that the public approval requirement for these bonds be satisfied in the same manner as if the bonds were issued by the governmental unit that charters the issuing corporation.

8. Change in use of facilities financed with private activity bonds

Under the Act, as under prior law, interest on bonds may become taxable either retroactively to the date of issue or (if specifically provided in the Code) prospectively, if certain events occur. The Act provides that, in addition to any such loss of tax-exemption, certain expenditures by persons using property financed with private activity bond proceeds become nondeductible for Federal income tax purposes if a change in use occurs.[190] Specifically, interest (including the interest element of other amounts paid for use of a bond-financed facility) becomes nondeductible if property financed with the proceeds of these bonds is used in a manner not qualifying for tax-exempt financing at any time before the bonds are redeemed.[191] These interest or other user charges are nondeductible, effective, in most cases, from the date the change in use occurs until the date on which the property again is used in the use for which the bonds were issued (or, if earlier, the date on which the bonds are redeemed).[192]

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[189] Under the Act, bonds issued pursuant to the Texas Veterans' Land Bond Program are treated as private activity bonds, and are subject to this public approval requirement. These bonds are issued pursuant to constitutional referenda approved, from time to time, by the voters of the State of Texas. Bonds issued as part of the Texas Veterans' Land Bond Program pursuant to any prior or future referendum approved by the voters of the State of Texas amending Article III of the Constitution of the State of Texas will satisfy the public approval requirements even though the identity of individual borrowers/mortgagors and the location of land to be financed is not known prior to or on the date such bonds are approved or issued. Such a referendum amending the Texas Constitution will satisfy the public approval requirements provided that a public hearing is held with respect to any issue subsequent to the first issue covered by the referendum. *See*, 132 Cong. Rec. H8362 (September 25, 1986) (statement of Mr. Rostenkowski); 132 Cong. Rec. S13960 (September 27, 1986) (colloquy between Senator Bentsen and Senator Packwood).

[190] These additional restrictions do not apply to property financed with governmental (*i.e.*, non-private activity) bonds; however, those bonds remain subject to all prior-law rules under which bond interest may become taxable.

[191] This requirement applies throughout the prescribed qualified project period in the case of projects for residential rental property financed with exempt-facility bonds.

a. Governmentally owned property

If the use of governmentally owned bond-financed property changes from a use qualifying for tax-exempt financing to a nonqualified use and a governmental unit continues to own the property, a portion of any rent or other user fee paid by the nongovernmental person using the property in the nonqualified use is nondeductible.

The nondeductible portion is an amount of rent or other user fees equivalent to the interest payments on that portion of the bonds attributable to the portion of the facility used in a nonqualified use. For example, if a governmentally owned airport terminal were converted to an office or retail complex, each nongovernmental user of the converted property would be denied deductions for rent and other user fees with respect to the property, to the extent of the interest payments on an allocable portion of the bonds. If the allocable bond interest payments exceeded any otherwise deductible rent or other user charges, the full amount of those deductions would be denied.

If bond-financed property is required to be governmentally owned, and ceases to be so owned, interest (including the interest component of any rent or other user charges) paid by the new owner with respect to the property is nondeductible.

b. Facilities (other than owner-occupied housing) owned by nongovernmental persons

If bond-financed facilities permitted to be owned by a person other than a governmental unit are converted to a use not qualifying for such tax-exempt financing, interest (including the interest component of any rent or other user charges) with respect to property financed with bond proceeds becomes nondeductible.[193] This restriction applies in the case of a change in ownership accompanied by an additional change in use as well as a change in use where the same person continues to own the property for Federal income tax purposes. (A permitted change in ownership, where the property continues to be used for a qualifying purpose, does not result in rent or other user charges becoming nondeductible.)

In the case of small-issue bonds, a change in use is deemed to occur if, for example, post-issuance capital expenditures result in the $10-million small-issue size limitation being violated.[194] Further, any change in use of bond-financed facilities to a use specifically prohibited under the Code (*see*, *e.g.*, new secs. 144(a)(8), 147(c)(6), and 147(e)) results in application of these penalties to the relevant facilities (or, in the case of qualified redevelopment bonds, with respect to land on which such facilities are located.)[195]

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[192] Unlike the restoration of future deductions for interest (or other) payments, bonds the interest on which becomes taxable do not regain tax-exempt status upon correction of any violation of the qualifications for tax-exemption.

[193] *See*, 3.a., above, for special change in use rules applicable to multifamily residential rental projects.

[194] A technical amendment may be necessary for the statute to reflect Congress' intent that facilities financed with qualified small-issue bonds be subject to the change in use restrictions.

c. Mortgage revenue bond-financed housing

If a residence financed with qualified mortgage bonds or qualified veterans' mortgage bonds ceases to be the principal residence of at least one of the mortgagors for a continuous period of 1 year or more, the mortgagors are denied a deduction for interest paid[196]with respect to the bond-financed mortgage loan on the residence.[197] For purposes of these rules, the term principal residence has the same meaning as under section 1034 of the Code (regarding nonrecognition of gain on the sale of a principal residence).

The Treasury Department is authorized to waive this penalty in cases where undue hardship otherwise would result and the noncompliance arises from circumstances beyond the control of the mortgagors (*e.g.*, a residence occupied by minor children of a deceased mortgagor).

Congress further was aware that certain housing comprised of fewer than five units, one of which is occupied by the owner, is treated as single-family housing under the qualified mortgage bond rules. In the case of such housing, whether the owner uses the property as his or her principal residence is determined by reference to use of the owner-occupied unit (or units).

d. Qualified 501(c)(3) bond-financed property

If the use of property financed with qualified 501(c)(3) bonds changes to a use not qualified for such financing (determined as of the time the bonds were issued), the section 501(c)(3) organization benefiting from the bonds is treated as using the property in an unrelated trade or business (*see*, sec. 511) from the date on which the change in use occurs. The organization is further treated as deriving income from the unrelated trade or business in an amount equal at least to the fair rental value of the property, with interest on the bond financing being nondeductible against the income of the unrelated trade or business.

In the case of a change in ownership of section 501(c)(3) bond-financed property (other than a transfer to a governmental unit or another section 501(c)(3) organization qualifying for the bond-financing[198]), the new owner of the property is denied deductions for interest (including the interest component of rent or other user charges) incurred in connection with the acquisition of the property.

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[195] The change in use rules are not intended to require any bond-financed property to meet targeting rules more stringent than those that applied to the bonds at the time of issue. For example, bonds for residential rental projects that are exempt from the new targeting requirements of the Act, pursuant to transitional exceptions, are required to meet the targeting requirements of sec. 103(b)(4)(A) of prior law (rather than new sec. 142(d)) in order to avoid the change in use penalties.

[196] Congress intended that the disallowance of interest deductions for bond-financed housing cease prospectively if the residence again qualifies as the mortgagor's principal residence. A technical amendment may be necessary for the statute to reflect this intent.

[197] Mortgage loans financed with qualified mortgage bond proceeds may be assumed only if the new mortgagor satisfies all requirements for initial borrowers. Therefore, this loss of interest deductions would not apply to such transfers of ownership. Congress was aware that certain veterans' mortgage programs permit assumptions of these financings by persons not qualified to be initial borrowers, and intended that changes in ownership accompanied by such assumptions not be treated as a change in use for purposes of the Act provided the loan assumption satisfies all requirements of the applicable veterans' mortgage bond program (as in effect on the date of the Act's enactment).

[198] *See, e.g.*, sec. 147(f) (regarding the $150-million-per-institution limit on outstanding nonhospital bonds).

e. Proportionate disallowance in the case of partial change in use

The Treasury Department is authorized to prescribe regulations for allocating interest on bond-financed loans in the case of a change in use (or ownership) of only a portion of a facility (or a portion of the facilities financed by an issue).[199] In general, Congress anticipated that these regulations will provide that interest is allocated proportionately to all users of the facility based upon factors such as relative cost, floor space occupied, relative rental value, or another comparable method. In making this allocation, each user (owner) is treated as the sole user (owner) of all common elements of a facility.

9. Restrictions on Federally guaranteed bonds

The Act retains the provision of prior law denying tax exemption for interest on Federally guaranteed bonds.[200] Prior-law exceptions to this provision are also retained. The exception for guarantees by the Bonneville Power Authority (BPA) pursuant to the Northwest Power Act (16 U.S.C. sec. 839d) as in effect on October 22, 1986, is permanently extended by the Act.[201]

As under prior law, an exception to the Federal guarantee rule is included permitting the District of Columbia to issue certain tax-exempt bonds. This exception does not apply to the issuance of exempt-facility, small-issue, or student loan bonds by the District of Columbia, but does allow the District to issue qualified redevelopment bonds.[202]

As under prior law, Congress intended that the substance of a transaction, rather than its form, will govern in determining whether a Federal guarantee is present.[203]

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[199] In the case of a partial change in use (including a partial change in ownership) where an interest element is imputed as a portion of another user fee (*e.g.*, rent), the maximum amount treated as nondeductible will be the amount of the rent or other user fee, but not exceeding an allocable amount of interest on the underlying bond financing.

[200] Other provisions retained by the Act include, but are not limited to, (i) the requirement that most tax-exempt bonds be issued in registered form, and (ii) special requirements pertaining to non-Code bonds. Thus, as under prior law, tax-exemption for all bonds may be derived only from the Internal Revenue Code, including tax-exemption for interest on all bonds authorized to be issued under certain pre-1984 non-Code statutes. As a condition of receiving tax-exemption, these bonds must satisfy all requirements for tax-exemption that apply to bonds the proceeds of which are used for a comparable purpose for which tax-exemption is authorized under the Code. Non-Code bonds for which no comparable tax-exempt use is authorized under the Code are not eligible for tax-exemption.

[201] A technical amendment may be necessary for the statute to reflect Congress' intent that this exception be permanently extended. Such an amendment was included in the versions of H. Con Res. 395 that passed the House and the Senate in the 99th Congress.

[202] A technical amendment may be necessary for the statute to reflect Congress' intent with respect to issuance of qualified redevelopment bonds by the District of Columbia. Such an amendment was included in the versions of H. Con. Res. 395 which passed the House of Representatives and the Senate in the 99th Congress.

[203] Certain provisions of other legislation have established Federal entities to guarantee certain types of tax-exempt bonds, while stating that the guarantees are not (or may not) be treated as Federal guarantees. Congress intended that the substance of these guarantee transactions, as opposed to any statements as to form or intent in the enacting legislation, govern their treatment under the tax laws. Thus, guarantees by federally chartered and controlled entities like the new College Construction Loan Insurance Association established in P.L. 99-498 are treated as Federal guarantees that are prohibited by the rules governing tax-exempt financing. *See*, 132 Cong. Rec. E3392 (October 2, 1986) (statement of Mr. Rostenkowski).

10. Cost recovery for bond-financed property

The Act provides that bond-financed property for which nongovernmental ownership is permitted generally is not eligible for full cost recovery deductions, to the extent that the property is financed with tax-exempt bonds.[204] This limitation applies both to the first owner of the property and to any subsequent owners who acquire the property while the bonds (including any refunding issues) are outstanding.

Bond-financed property generally

Costs of most property financed with tax-exempt bonds are recovered using the nonincentive depreciation system. These rules provide for cost recovery using the straight-line method, over recovery periods that are generally longer than those applied to other property. Except in the case of qualified residential rental projects, the costs of bond-financed real property are recovered using a 40-year recovery period and the straight-line method.

Qualified residential rental projects

The Act provides special, more liberal cost recovery rules for qualified residential rental projects financed with exempt-facility bonds. Under these rules, costs of such projects are recovered over a 27.5-year period using the straight-line method (*i.e.*, the same provisions that apply to residential rental property generally).

11. Information reporting for all tax-exempt bonds

The Act extends to all bonds on which interest is tax-exempt information reporting requirements similar to those that applied under prior law to IDBs, qualified mortgage bonds, qualified veterans' mortgage bonds, student loan bonds, and section 501(c)(3) organization bonds. In general, the information required to be reported to the Treasury Department is the same as required under prior law.

Congress recognized that certain information required under prior law with respect to IDBs and mortgage revenue bonds is inapplicable in the case of bonds for general government operations, because governmental bonds are not issued exclusively to finance specific facilities. The Act, therefore, authorizes the Treasury to vary the specific information that is required with respect to facility and non-facility bonds, and in other appropriate cases. The Act further authorizes the Treasury Department to grant an extension of time for filing any required information report if the late filing is not due to willful neglect,[205] and thereby to waive loss of tax-exemption on the issue.

Congress understood that obligations issued to finance activities of governmental units may be issued in small amounts in some cases, and that requiring a separate information report for each issue might involve undue hardship. Congress intended, therefore, that the Treasury Department may, in appropriate cases, permit issuers to file a simplified, consolidated report for these small issues.

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[204] A more complete description of the depreciation provisions of the Act is found in Title II., Part A., above.

[205] A technical amendment may be necessary for the statute to reflect Congress' intent that the standard for waiving loss of tax-exemption is the absence of willful neglect (rather than reasonable cause).

Effective Dates

Definition of private activity bond

General rules

Private use and loan limitations

The amendments to the definition of private activity bond generally apply to bonds (including refunding bonds) issued on or after September 1, 1986.[206] These include the 10-percent trade or business use test (both the general 10-percent limit and the 10-percent or $15-million limit for output facilities); the 5-percent unrelated use limitation; and the addition of a $5-million limitation for purposes of the private loan restriction.[207]

The September 1, 1986, effective date does *not* apply for purposes of the modified security interest test, described below. This effective date also does not apply to bonds which under prior law were (1) industrial development bonds (IDBs), (2) bonds that would have been IDBs, had section 501(c)(3) organizations been treated as private persons engaged in trades or businesses, (3) qualified student loan bonds, (4) mortgage revenue bonds, or (5) other private ("consumer") loan bonds (using the prior-law definition)[208] for which tax-exemption was permitted under prior law.[209] With respect to these bonds, these provisions of the Act generally are effective for bonds (including refunding bonds) issued after August 15, 1986.

Modification of security interest test

The amendment to the security interest test, to provide that the test takes into account both direct and indirect payments made by users of bond-financed property (whether or not formally pledged), applies to bonds (including refunding bonds) issued after August 15, 1986.

Use pursuant to certain management contracts

The direction to the Treasury Department to modify its advance ruling guidelines with respect to private use pursuant to certain management contracts was effective on October 22, 1986.

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[206] For a fuller description of these effective dates, *see*, Joint Statement by The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, The Honorable Bob Packwood (R., Ore.), Chairman, Committee on Finance, The Honorable John J. Duncan (R., Tenn.), Ranking Member, Committee on Ways and Means, The Honorable Russell Long (D., La.), Ranking Member, Committee on Finance, and The Honorable James A. Baker, III, Secretary of the Treasury, on the Effective Dates of Pending Tax Reform Legislation, March 14, 1986; and Joint Statement of Chairman Rostenkowski, Chairman Packwood, and Secretary Baker, July 17, 1986 (reproduced as Appendices XIII-1 and XIII-2, *infra*).

[207] The revisions to the exceptions to the private loan restriction (including continuation of the prior-law exceptions) are effective for bonds issued after August 15, 1986.

[208] These private loan bonds include bonds issued as part of the Texas Veterans' Land Bond Program, the Oregon Small-Scale Energy Conservation and Renewable Resource Loan programs, and the Iowa Industrial New Jobs Training Program.

[209] This rule applies equally to non-Code bonds, regardless of when issued, that are comparable to any of the foregoing categories.

Transitional exceptions

The Act includes three generic transitional exceptions to the amendments to the definition of private activity bond (including the modification of the security interest test). These rules apply, respectively, to bonds (other than refunding bonds) for certain in-progress projects; certain current refunding bonds; and certain advance refunding bonds.

Certain "in-progress" projects

The first transitional exception is provided for bonds (other than refunding bonds) with respect to facilities[210]—

(1) the original use of which commences with the taxpayer and the construction (including reconstruction or rehabilitation) of which began before September 26, 1985, and is completed on or after that date;

(2) the original use of which commences with the taxpayer and with respect to which (a) a binding contract to incur significant expenditures for construction (including reconstruction or rehabilitation) of facilities financed with the bonds was entered into before September 26, 1985, and is binding at all times thereafter, and (b) part or all of such expenditures are incurred on or after that date; or

(3) acquired after September 25, 1985, pursuant to a binding contract entered into on or before that date and that is binding at all times after that date.

As with the general effective date provisions, bonds eligible for this transitional exception are bonds that, under prior law, were not IDBs, qualified mortgage bonds, qualified veterans' mortgage bonds, student loan bonds, other private loan bonds for which tax-exemption was permitted under prior law, or non-Code bonds comparable to any of the foregoing.

This transitional exception further applies only to facilities for which the bond financing in question was approved by a governmental unit (or by voter referendum) before September 26, 1985. Governmental approval for this purpose includes approval by means of an inducement resolution or, if the governmental unit generally does not adopt inducement resolutions for the type of bond concerned, other comparable approval.

For purposes of the exception for facilities qualifying under (1) or (2), above, construction of a facility is deemed complete when the facility is placed in service for Federal income tax purposes.

Whether or not an arrangement constitutes a contract is determined under the applicable local law. A binding contract is not considered to have existed before September 26, 1985, however, unless the property to be acquired or services to be rendered were specifically identified or described before that date.

A binding contract for purposes of these transitional exceptions exists only with respect to property or services for which the taxpayer is obligated to pay under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of articles and also grants an option to purchase additional articles, the contract is binding only to the extent of the articles that must be purchased.

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[210] Bonds issued pursuant to this exception include only those issues issued to finance the transitioned facility. The fact that a portion of the proceeds of a larger, multipurpose issue is used for a transitioned facility does not exempt the issue from any of the provisions of the Act.

A contract may be considered binding on a person even though (1) the contract contains conditions which are under the control of a person not a party to the contract, or (2) the person has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract that was binding on September 25, 1985, will not be considered binding at all times thereafter if it is modified (other than as described in (2) above) after that date. Additionally, for purposes of the binding contract exception, payments under an installment payment agreement are incurred no later than the date on which the property that is the subject of the contract is delivered, rather than the due date of each installment.

For purposes of the binding contract exception, significant expenditures means expenditures in excess of 10 percent of the reasonably anticipated cost of the construction, reconstruction, or rehabilitation of the facilities.

Under the Act, an issuer may elect not to have this transitional exception apply with respect to any issue. If the issuer so elects, the applicable provisions of the Act shall apply to the issue.

Certain current refundings

A second transitional exception is provided with respect to certain current refunding bonds.[211] This exception applies to current refundings of bonds issued before the otherwise applicable effective date[212] (including a series of refundings in which the original bond was issued before that date), if—

(1) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds[213], and

(2) (a) the weighted average maturity of the refunding issue does not exceed 120 percent of the reasonably expected economic life of the property identified as being financed with the refunded bonds (in a series of refundings, the original bonds) when those bonds were issued, or

(b) the final maturity date of the refunding bonds is not later than 17 years after the issuance of the refunded (original) bonds.[214]

This exception applies, for example, to bonds that were governmental bonds under prior law but are private activity bonds under the Act. In addition to pre-August 16, 1986, bonds, the exception applies to current refundings (including a series of refundings) of bonds to which the "in progress" transitional exception described in the preceding section applies. The exception does not change prior-law rules prohibiting refundings of various types of bonds (*e.g.*, private loan bonds and certain non-Code bonds) issuance of which was prohibited or restricted under the Deficit Reduction Act of 1984 or other previous revenue Acts.

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[211] Advance refunding bonds, as defined in the Act, may not be issued pursuant to this exception.

[212] This date is August 16, 1986, for private activity bonds, and September 1, 1986, for bonds other than private activity bonds.

[213] Any current refunding issue for an amount in excess of that required to redeem the outstanding principal amount of the refunded bonds (assuming redemption at no greater than par value) does not qualify for this exception.

[214] A similar rule applies to qualified mortgage bonds and qualified veterans' mortgage bonds, using a 32-year rather than a 17-year limit. (This rule is discussed under the effective dates for mortgage revenue bonds.)

Certain advance refundings

A third exception is provided permitting advance refunding of bonds that were not IDBs or private loan bonds[215] under prior law, subject to the new restrictions on advance refundings of bonds other than private activity bonds (including, except in the case of bonds for output facilities, the private activity bond volume limitation). Bonds qualifying for this exception must be used exclusively to advance refund the refunded bonds. This exception does not change prior-law rules prohibiting advance refundings of various types of bonds (*e.g.*, private loan bonds and certain non-Code bonds) issuance of which was prohibited or restricted under the Deficit Reduction Act of 1984 or other previous revenue Acts.

Exceptions for certain private loan bonds

The repeal of the sunset date for the Texas Veterans' land bond program, the provisions regarding the Iowa Industrial New Jobs Training Program, and the extension of the provisions regarding the Oregon energy programs are effective for bonds issued after August 15, 1986.

Bonds for volunteer fire departments

The extension and modification of authority for certain volunteer fire departments to issue tax-exempt bonds is effective for bonds issued after August 15, 1986.

Exceptions allowing issuance of certain private activity bonds

Except as provided below, the remaining provisions affecting tax-exempt bonds are effective for bonds (including refunding bonds) issued after August 15, 1986. Transitional exceptions are provided to many of these effective dates under circumstances similar to those described with respect to the definition of private activity bond, above. For purposes of these transitional exceptions, the determination of whether original use commences with the taxpayer; of whether construction (including reconstruction or rehabilitation) began before, and is completed on or after, a specified date; of whether significant expenditures are made; and of whether a binding contract existed (and pursuant to which expenditures are made after a specified date) is made in the same manner as described in that section. Additionally, the determination of whether a facility is described in a properly adopted inducement resolution (or other comparable approval) is made in the same manner as described in that section.

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[215] A technical amendment may be necessary for this statute to reflect Congress' intent that bonds used to make excluded loans (so-called tax assessment bonds) may be advance refunded under this exception, provided that the bonds would be governmental bonds (but for the private loan bond restriction).

Exempt-facility and industrial park bonds

The amended rules governing issuance of exempt-facility bonds are effective for bonds (including refunding bonds) issued after August 15, 1986. These provisions include the termination of certain activities for which exempt-activity IDBs could be issued under prior law and the amendments to the conditions of exemption for bonds to finance certain continued exempt facilities (formerly exempt-activity IDBs), including bonds for airports, docks and wharves, mass commuting facilities, and multifamily residential rental projects.[216] This effective date also applies to the amendments to the definition of functionally related and subordinate facilities, to exclude office space unrelated to day-to-day operations at the facility. The same effective date also applies to the repeal of industrial park IDBs.

A transitional exception from these rules is provided for bonds (other than refunding bonds) that could be issued under the prior-law IDB rules, but that may not be issued under the Act. This transitional exception applies to bonds for facilities with respect to which the commencement of construction (including reconstruction or rehabilitation), binding contract, or acquisition rules described in the discussion of effective dates for the new rules defining private activity bonds are satisfied.

A second transitional exception applies in the case of certain current refunding bonds. This exception applies to current refundings (including a series of refundings) of bonds issued before August 16, 1986,[217] which bonds qualified for tax-exemption under prior law, but do not so qualify under the Act, provided that the rules of the transitional exception for current refundings of certain governmental bonds (described under the effective date for the definition of private activity bonds, above) are satisfied.

The requirement that 95 percent of the net proceeds of exempt-facility bonds be used to finance exempt facilities (including functionally related and subordinate facilities) applies to bonds issued after August 15, 1986, except for bonds covered under the second transitional exception above (for current refunding bonds).

The option to issue tax-exempt bonds for qualified hazardous waste facilities applies to bonds issued after August 15, 1986.

Qualified small-issue bonds

The amendments to the small-issue bond (formerly small-issue IDB) provisions apply to bonds (including refunding bonds) issued after August 15, 1986. This includes the extension of the sunset date for manufacturing facilities and first-time farmers; the amendments to the first-time farmer exception; the requirement that 95 percent of net proceeds be used for an exempt purpose; and the $250,000 lifetime limit for depreciable farm property.

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[216] This includes, *inter alia*, the requirement that all property financed with exempt-facility issues for airports, docks and wharves, and mass commuting facilities be governmentally owned.

[217] This rule, and subsequent transitional exceptions for current refunding bonds (where appropriate), also apply to current refundings of bonds issued pursuant to the transitional exception for certain in-progress projects, described in the preceding paragraph, except that such refundings of transitioned bonds must comply with all provisions of the Act that applied to the refunded bonds (in addition to all such provisions that apply to bonds issued under the refunding transitional exception generally).

A transitional exception to the 95 percent of net proceeds rule and the $250,000 limit on depreciable farm property applies to certain current refunding bonds. This exception applies to current refundings (including a series of refundings) of bonds issued before August 16, 1986, provided that the rules of the transitional exception for current refundings of certain governmental bonds (described under the effective date for private activity bonds, above) are satisfied.[218]

Student loan bonds

The provisions regarding student loan bonds apply to bonds (including refunding bonds) issued after August 15, 1986.

A transitional exception is provided permitting current refundings (including a series of refundings) of qualified student loan bonds issued before August 16, 1986, which qualified for tax-exemption under prior law, but do not qualify under the Act. This exception applies provided that the rules of the transitional exception for current refundings of certain governmental bonds (described under the effective date for the definition of private activity bond, above) are satisfied. Under these rules, as applied to student loan bonds, the amount of the refunding bonds may not exceed the outstanding amount of the refunded bonds,[219] and the last maturity date of the refunding bonds may be no later than 17 years after the date of issuance of the refunded bonds (the original bonds in the case of a series of refundings). Congress intended that, as under prior law, the period provided for financing student loans in the case of these current refunding bonds be determined from the date of issue of the refunded bonds (the original bonds in the case of series of refundings), rather than a new period commencing on the date of the refunding.

Qualified mortgage bonds

The amendments to the qualified mortgage bond provisions are effective with respect to bonds (including refunding bonds) issued after August 15, 1986.

A transitional exception is provided permitting current refundings (including a series of refundings) of qualified mortgage bonds issued before August 16, 1986, which qualified for tax-exemption under prior law, but do not qualify under the Act, provided that the rules of the transitional exception for current refundings of certain governmental bonds (described under the effective date for the definition of private activity bond, above) are satisfied. Under these rules, as applied to mortgage revenue bonds, the amount of the refunding bonds may not exceed the outstanding amount of the refunded bonds,[220] and the last maturity date of the refunding bonds may be no later than 32 years from the date of issuance of the refunded bonds (the original bonds in the case of a series of refundings). Congress intended that, as under prior law, the period allowed to provide financing for qualified mortgagors in the case of these current refunding bonds be determined from the date of issue of the refunded bonds (the original bonds in the case of a series of refundings), rather than a new period commencing on the date of the refunding.[221]

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[218] A technical amendment may be necessary to reflect Congress' intent with respect to post-sunset date refundings of small-issue bonds. *See*, 3.b., above.

[219] Any current refunding issue for an amount in excess of that required to redeem the outstanding principal amount of the refunded bonds (assuming redemption at no greater than par value) does not satisfy this requirement.

[220] Any current refunding issue for an amount in excess of that required to redeem the outstanding principal amount of the refunded bonds (assuming redemption at no greater than par value) does not satisfy this requirement.

The amendments relating to limited equity cooperative housing corporations apply to bonds issued after August 15, 1986.

The amendments to the targeting rules for mortgage credit certificates (MCCs) apply to credits issued pursuant to elections to trade in bond authority for authority to issue MCCs, which elections are made after August 15, 1986.[222] The increase in the MCC trade-in rate similarly applies to elections made after August 15, 1986.

Qualified veterans' mortgage bonds

The amendments to the qualified veterans' mortgage bond provisions apply to bonds (including refunding bonds) issued after August 15, 1986.

A transitional exception is provided permitting current refundings (including a series of refundings) of bonds issued before August 16, 1986, which qualified for tax-exemption under prior law, but do not qualify under the Act, under the same conditions as qualified mortgage bonds (discussed above). As in the case of qualified mortgage bonds, Congress intended that the period during which financing may be provided to mortgagors be determined from the date of issue of the refunded bonds (the original bonds in the case of a series of refundings), rather than a new period commencing on the date of the refunding.

Qualified redevelopment bonds

The provisions permitting tax exemption for interest on qualified redevelopment bonds apply to bonds issued after August 15, 1986.

Qualified 501(c)(3) bonds

The provisions regarding qualified 501(c)(3) bonds generally apply to bonds (including refunding bonds) issued after August 15, 1986. These provisions include the $150-million limitation with respect to nonhospital bonds and the requirement that facilities be owned by a section 501(c)(3) organization or by a governmental unit.

A transitional exception is provided from the new ownership requirement for qualified 501(c)(3) bonds for bonds for facilities with respect to which the commencement of construction (including reconstruction or rehabilitation), binding contract, or acquisition rules described under the effective date for the definition of private activity bond, above, are satisfied.

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[221] A technical amendment may be necessary for the statute to reflect Congress' intent that the repeal of the prior-law annual policy statement requirement be effective for current refunding bonds issued after August 16, 1986, notwithstanding the transitional exception for current refunding bonds contained in Act sec. 1313(a)(1). *See*, 3.d., above.

[222] A technical amendment may be necessary for the statute to reflect Congress' intent regarding this effective date. Such an amendment was included in the versions of H. Con. Res. 395 that passed the House of Representatives and the Senate in the 99th Congress.

A second transitional exception to the ownership requirement applies to certain current refunding bonds.[223] This exception applies to refundings (including a series of refundings) of bonds issued before August 16, 1986, which bonds qualified for tax-exemption under prior law, but not under the Act, provided that the rules of the transitional exception for current refundings of governmental bonds (and certain other requirements described under the *Explanation of Provisions*) are satisfied.

Advance refundings of bonds issued for section 501(c)(3) organizations before August 16, 1986, are permitted under a further transitional exception, without regard to whether the refunded bonds satisfy the new use of proceeds and ownership requirements applicable to qualified 501(c)(3) bonds. These advance refundings must comply with the new advance refunding restrictions applicable to qualified 501(c)(3) bonds. A special transitional rule permits the such first advance refunding of a pre-January 1, 1986, bond, even if a beneficiary of the bonds has more than the $150 million in non-hospital bonds outstanding before or as a result of the refunding issue. Such bonds do count, however, in applying the limit to future issues.

Private activity bond volume limitation

General rules

Except as provided below, the new State private activity bond volume limitations apply to bonds (including refunding bonds) issued after August 15, 1986.[224] An exception is included in the substantive rules for these limitations exempting certain current refundings of bonds otherwise subject to the limitations (*see*, 4., above).

Advance refundings, where permitted under the Act, generally are subject to the new State volume limitations. Advance refundings of pre-August 16, 1986, bonds, are subject to the new volume limitations to the extent that the refunded bonds would be if they were originally issued on the date of the advance refunding and if more than 5 percent of the net proceeds of the refunded bond are used for output projects (not including facilities for the furnishing of water). However, the new definition of private activity bond (*e.g.*, the 10-percent private business tests) does not apply, to make the entire issue subject to these volume limitations.

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[223] An exception for certain current refunding bonds for purposes of the $150-million-per-institution limit on non-hospital bonds is included in the substantive rules pertaining to that limit.

[224] Certain bonds, issuance of which is authorized under generic transitional exceptions in the Act (Act secs. 1312 and 1313) involve a use of proceeds comparable to that of categories of private activity bonds (*e.g.*, exempt facility bonds) for which carryforward elections may be made under the State new private activity bond volume limitations. In such cases, Congress intended that carryforward elections under these new private activity bond volume limitations (for years 1986 and thereafter) be permitted to the same extent as if the bonds were identified in new Code sec. 146(f)(5), provided all such bonds are issued within the allowable carryforward period for such bonds. A technical amendment may be necessary for the statute to reflect this intent. *See also*, note 237, below, for a comparable rule for certain project-specific transitional exceptions.

Transitional exceptions

The Act includes two general transitional exceptions under which bonds issued after August 15, 1986, are not subject to the new private activity bond volume limitations. Both of these exceptions require that the bonds be issued with respect to facilities satisfying the commencement of construction (including reconstruction or rehabilitation), binding contract, or acquisition rules described under the discussion of effective dates for the new definition of private activity bond.

If the bond-financed facilities satisfy one of these transitional exceptions, bonds that were not subject to State volume limitations under prior law (*e.g.*, bonds for multifamily residential rental property and the nongovernmental use portion of governmental bonds) are not subject to the new State private activity bond volume limitations.

Second, if the bond-financed facilities satisfy one of the transitional exceptions, bonds that were subject to a State volume limitation under prior law (*i.e.*, most other IDBs and all student loan bonds), are not subject to the new private activity bond volume limitations to the extent that the bonds are issued pursuant to a carryforward election of bond authority for 1984 or 1985 that was made under the prior-law State volume limitations for student loan bonds and most IDBs, which carryforward election was filed with the Treasury Department before November 1, 1985.[225] (Carryforwards of 1984 bond authority must have been made in timely fashion, *i.e.*, by February 25, 1985.) Bonds for which carryforward elections were not allowed under prior law (including qualified mortgage bonds and small-issue bonds) or were not made may not qualify for this exception.

Congress was aware that carryforward elections may have been made with respect to only a portion of the bond authority required for a project. Bonds in excess of the amount to which the carryforward election applied are subject to the new private activity bond volume limitations.

Repeal of prior-law volume limitations

In connection with the imposition of the new State volume limitation, prior-law volume limitations (except for the qualified veterans' mortgage bond limitations) are repealed, effective for bonds issued after August 15, 1986. No carryforwards of 1986 authority under those prior-law volume limitations are permitted under any circumstances.

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[225] The November 1, 1985, date is extended to January 1, 1986, with respect to facilities covered by a special generic transitional exception to the depreciation and investment tax credit provisions of the Act for certain solid waste disposal facilities (sec. 204(a)(8) of the Act) or by certain project-specific transitional exceptions (Act sec. 1315(d)). The generic exception covers solid waste disposal facilities—

(i) with respect to which a service contract was entered into before March 2, 1986, or

(ii) with respect to which the service recipient or a governmental unit (or a related party to either) had made a financial commitment to the project before March 2, 1986, equal to or exceeding $200,000.

Governmentally owned facilities qualify for this special exception to the new State private activity bond volume limitations if the facilities would qualify for prior-law depreciation and investment credit if they were nongovernmentally owned.

Arbitrage restrictions

The arbitrage provisions of the Act apply generally to bonds (including refunding bonds) issued after August 15, 1986. In the case of certain bonds (including refunding bonds) that were treated as governmental bonds under prior law,[226] this date is extended to August 31, 1986, for a limited number of the new arbitrage restrictions.

Special effective dates, which override the general rules above, apply in the following cases:

Restriction on annuities.—The restriction on investment in annuity contracts applies to bonds (including refunding bonds) issued after September 25, 1985.

Determination of bond yield.—The new method of determining bond yield (*i.e.*, the reversal of the *State of Washington* case) applies to bonds (including refunding bonds) issued after December 31, 1985.

Election to forego temporary periods; treatment of credit enhancement fees under arbitrage restrictions.—The direction to the Treasury Department to modify its regulations to delete the election to earn higher arbitrage by foregoing temporary periods applies to bonds issued on or after September 1, 1986.

The direction tc treat certain credit enhancement fees as interest for purposes of the arbitrage restrictions was effective on October 22, 1986 (*i.e.*, the date of enactment).[227]

Rebate requirement.—The arbitrage rebate provisions of the Act are effective as follows:

(1) In the case of certain bonds that were treated as governmental under prior law[228] (except bonds issued to fund certain pools, as described in (2) below), these provisions apply to bonds (including refunding bonds) issued on or after September 1, 1986.

(2) In the case of governmental bonds that are issued to fund certain pools, the arbitrage rebate requirement applies to bonds (including refunding bonds) issued after 3:00 p.m., E.D.T., July 17, 1986.

Issues are subject to the special effective date described in (2), above, if they satisfy one or more of the following four criteria:

(A) The proceeds of the issue are to be used to fund a pool or pools to make loans to governmental units other than governmental units that are subordinate (determined under applicable State or local law) to the issuer (or the governmental unit on behalf of which the issuer acts) and the jurisdiction of which is within the jurisdiction of the issuer or the governmental unit on behalf of which the issuer acts.[229]

(B) The proceeds of the issue are to be used to fund a pool or pools with respect to which less than 75 percent of the proceeds of the issue is to be used to make or finance loans to initial borrowers to finance projects identified (with specificity) by the issuer, on or before the date of issue, as projects to be financed with the proceeds of such issue.

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[226] *See*, the Joint Statement on Effective Dates of March 14, 1986, *supra*.

[227] This change generally was not intended to apply to bonds issued before August 16, 1986.

[228] *See*, the Joint Statement on Effective Dates of March 14, 1986, *supra*.

[229] A pooled financing is to be deemed to satisfy the requirement that bond proceeds be used exclusively for activities of the issuer and subordinate governmental units in a case where (1) the physical boundaries of the city/issuer are coterminous with those of the county in which it is located, and (2) the bond proceeds are for use by an independent hospital authority serving only the city/issuer except for certain *de minimis* areas that physically are entirely surrounded by the city, but which legally are independent jurisdictions under applicable State law. *See*, 132 Cong. Rec. p. E3392 (October 2, 1986) (statement of Mr. Rostenkowski).

(C) The proceeds of the issue are to be used to fund a pool or pools and, on or before the date of issue, binding loan commitments have not been entered into by such initial borrowers to borrow at least 25 percent of the proceeds of the issue.

(D) The maturity date of any bond issued as part of the issue exceeds 30 years, and any principal repayment on any loan is to be used to make or finance additional loans.

Paragraphs (B) and (C) apply only if (i) bonds were not issued by the issuer before January 1, 1986, to fund similar governmental bond pools, or (ii) if the issuer had established a similar pool or pools before that date, issuance of bonds for such pools during 1986 exceeded 250 percent of the average annual issuance for such pools during calendar years 1983, 1984, and 1985.

For purposes of the special effective date for pooled financings, an issue of bonds sold to a securities firm, broker, or other person acting in the capacity of an underwriter or wholesaler is not treated as issued before such bonds have been re-offered to the public (pursuant to final offering materials) and at least 25 percent of such bonds actually have been sold to the public.

(3) The rebate requirement for qualified veterans' mortgage bonds applies to bonds (including refunding bonds) issued after August 15, 1986.[230]

(4) In all other cases, the arbitrage rebate provisions apply to bonds (including refunding bonds) issued after December 31, 1985.

Congress intended that no payment of rebate, under any of the above effective dates, be due before December 21, 1986 (*i.e.*, 60 days after the date of enactment). (This extension of time for remitting rebate payments does not apply to bonds to which a rebate requirement applied under prior law.)

Limitation on investment in nonpurpose investments.—The extension of the prior-law IDB limitation on investment in nonpurpose investments applies to bonds (including refunding bonds) issued after August 15, 1986.

Modification of SLGS program.—The direction to the Treasury Department to modify its State and Local Government Series (SLGS) program was effective on October 22, 1986. The revised SLGS program was to be in effect on January 1, 1987.

Restrictions on advance refundings

The new restrictions on advance refunding bonds apply as follows:

(1) In the case of certain bonds that were governmental bonds under prior law,[231] the new restrictions apply to advance refunding bonds issued on or after September 1, 1986.

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[230] A technical amendment may be necessary for the statute to reflect Congress' intent that this requirement apply to refundings of bonds originally issued before January 1, 1986.

[231] *See*, the Joint Statement on Effective Dates of March 14, 1986, *supra*.

(2) In the case of any other advance refundings permitted under the Act, the restrictions apply to advance refunding bonds issued after August 15, 1986.

(3) The new 30-day initial temporary period for advance refunding bonds applies to all advance refunding bonds issued after December 31, 1985.

(4) The prohibition on abusive transactions applies to advance refunding bonds issued after the applicable effective date (August 15, 1986, or August 31, 1986).[232]

A transitional exception applies to permit advance refundings of certain tax-exempt governmental and section 501(c)(3) organization bonds that may not be originally issued under the Act. These advance refundings generally are subject to the new substantive restrictions on advance refundings, and certain other provisions of the Act.

For advance refunding bonds issued under this transitional exception, amounts deposited in an advance refunding escrow account are exempt from the 150 percent of debt service limitation on investment in materially higher yielding nonpurpose investments. Amounts invested in such an escrow account are not, however, treated as spent for the governmental purpose of the borrowing until they are used to redeem the refunded bonds; thus, the arbitrage rebate requirement applies to such proceeds, as well as to other proceeds (including transferred proceeds) for which an exception is not provided under the expanded rebate requirement, discussed above.

Miscellaneous restrictions on private activity bonds

Limitation on bond-financing of costs of issuance

The limitation on bond financing of private activity bond issuance costs, to 2 percent of the face amount of the issue (3.5 percent for certain mortgage revenue bond issues), applies to all private activity bonds (including refunding bonds) issued after August 15, 1986. Similarly, the new definition of net proceeds, which requires all bond-financed costs of issuance to be financed out of the so-called "bad money" portion of an issue applies to bonds (including refunding bonds) issued after August 15, 1986.

Relationship of bond maturity to life of assets

The extension of the prior-law IDB rule limiting bond maturity in relation to the life of the property financed applies to bonds (including refunding bonds) issued after August 15, 1986.

Restrictions on financing certain specified activities

The extension to all private activity bonds (except bonds for qualified 501(c)(3) health club facilities and qualified redevelopment bonds) of the prior-law IDB rule limiting or prohibiting the financing of certain facilities applies to bonds (including refunding bonds) issued after August 15, 1986.

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[232] A technical amendment may be necessary for the statute to reflect Congress' intent that this effective date be August 15, 1986 (or August 31, 1986, where applicable), rather than December 31, 1986. Such an amendment was included in the versions of H. Con. Res. 395 that passed the House of Representatives and the Senate in the 99th Congress.

A transitional exception is provided for bonds (other than refunding bonds) which could be issued under prior law, but not under the Act, and with respect to which the commencement of construction (including reconstruction or rehabilitation), binding contract, or acquisition rules described in the discussion of the effective dates for the definition of private activity bond are satisfied.

A further transitional exception is provided for current refundings of bonds issued before August 16, 1986, that qualified for tax-exemption under prior law, but do not qualify under the Act, provided that the requirements of the transitional exception for current refundings of certain governmental bonds (described under the effective date for the definition of private activity bond, above) are satisfied.

Public hearing and approval or voter referendum requirement

The extension of public hearing and approval or voter referendum requirements to all private activity bonds applies to such bonds (including refunding bonds) issued after December 31, 1986.[233] Current refunding bonds are exempt from this requirement provided that (i) the requirements of the transitional exception for current refundings of certain governmental bonds (described under the effective date for the definition of private activity bond, above) are satisfied, and (ii) the weighted average maturity of the refunding bonds is not later than the weighted average maturity of the refunded bonds.

Bonds previously subject to this requirement (*i.e.*, exempt-facility and small-issue bonds) remain continuously subject to the requirement between August 15, 1986, and December 31, 1986.

Change in use rules

The new penalties for changes in use of facilities financed with private activity bonds, to uses not qualifying for tax-exempt financing, apply to changes in use (or ownership) taking place after August 15, 1986, but only with respect to financing (including refinancing) provided after that date.

Information reporting requirements

The extension of information reporting requirements to all tax-exempt bonds applies to bonds (including refunding bonds) issued after December 31, 1986. Bonds previously subject to information reporting requirements (*i.e.*, exempt-facility and small-issue bonds, student loan bonds, and bonds for section 501(c)(3) organizations) remain continuously subject to those requirements between August 15, 1986, and December 31, 1986.

Certain targeted transitional exceptions

In addition to the generic transition rules described above, the Act provides certain targeted transitional exceptions from the new restrictions imposed by the Act for specifically described facilities or programs.[234] Each of these targeted transitional exceptions applies only to one described project or issue of bonds or to a limited group of described projects, and each is subject to a maximum dollar amount of bonds.[235] Additionally, these rules generally require that the transitioned bonds be issued before January 1, 1991.

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[233] A technical amendment may be necessary for the statute to reflect Congress' intent that this extension be effective for bonds issued after December 31, 1986 (rather than August 15, 1986).

Bonds which are the subject of project-specific transitional exceptions and which are private activity bonds (as defined by the Act) generally are exempt from the new private activity bond volume limitations only if (1) equivalent bonds issued under prior law would not have been subject to volume limitations (*e.g.*, bonds for residential rental housing, qualified redevelopment bonds, and the private use portion of governmental bonds),[236] or (2) the bonds are issued pursuant to carryforwards of prior law volume cap for calendar years 1984 or 1985, which timely carryforward elections were filed with the Treasury Department before January 1, 1986.[237]

Certain transitional exceptions provided in the Deficit Reduction Act of 1984 are also re-enacted by the Act. These transitional exceptions are those exempting a specifically described project, or a limited group of such projects, from one or more of the provisions of that Act. The Act generally re-enacts the 1984 Act transitional exceptions only if the transitioned bonds are issued before January 1, 1989.[238]

Revenue Effect of Tax-Exempt Bond Provisions

These provisions are estimated to increase fiscal year budget receips by $16 million in 1987, $69 million in 1988, $114 million in 1989, $192 million in 1990, and $231 million in 1991.

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[234] Congress intended that these project-specific transition rules would be in addition to any generic transition rules applicable under the Act.

[235] A technical amendment may be necessary for the statute to reflect Congress' intent that, subject to restrictions similar to those imposed on post-sunset refundings of qualified small-issue bonds, bonds authorized under these project-specific transitional exceptions may be currently refunded. Advance refundings of bonds authorized under these transitional exceptions is not permitted.

[236] This provision also applies to bonds for governmentally owned airports, docks and wharves, mass commuting facilities, and convention or trade show facilities.

[237] Certain of these project-specific transitional exceptions specifically describe the bonds authorized under the exceptions as exempt-facility or other types of bonds for which carryforward elections are permitted under the new State private activity bond volume limitations. In such cases, Congress intended that carryforward elections under the new State private activity bond volume limitations (for years 1986 and thereafter) be permitted to the same extent as if the bonds were identified in new Code sec. 146(f)(5), provided all such bonds are issued before the termination date for the transitional exception authorizing their issuance. A technical amendment may be necessary for the statute to reflect this intent.

[238] Re-enactment of these project-specific transition rules does not change the general prohibition contained in the 1984 Act and other previous revenue Acts on refunding certain obligations (*e.g.*, private loan bonds) that may not be originally issued under those Acts.

B. General Stock Ownership Corporations (GSOCs) (sec. 1303 of the Act and former secs. 1391-1397 of the Code) [239]

Prior Law

A State could establish a General Stock Ownership Corporation (GSOC) to serve as an investment fund for its citizens. GSOCs could elect to be exempt from federal income tax, and the shareholders would report as gross income their pro rata share of the GSOC's taxable income.

Reasons for Change

No GSOC has been organized since enactment of the authorizing legislation, and the period during which a GSOC could be formed—January 1, 1979, through December 31, 1983—has expired.

Explanation of Provision

The GSOC provisions are repealed.

Effective Date

The repeal of the GSOC provisions is effective as of January 1, 1984.

Revenue Effect

This provision has no effect on budget receipts in fiscal years 1987-1991.

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[239] For legislative background of the provision, *see:* H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 702; H. Rep. 99-426, p. 573; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 1517 and 1518; S. Rep. 99-313, pp. 800-1; and H. Rep. 99-841, Vol. II (September 18, 1986), p. II-762 (Conference Report).

APPENDIX XIII-1

JOINT STATEMENT BY THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, THE HONORABLE BOB PACKWOOD (R., ORE.), CHAIRMAN, COMMITTEE ON FINANCE, THE HONORABLE JOHN J. DUNCAN (R., TENN.), RANKING MEMBER, COMMITTEE ON WAYS AND MEANS, THE HONORABLE RUSSELL LONG (D., LA.), RANKING MEMBER, COMMITTEE ON FINANCE, AND THE HONORABLE JAMES A. BAKER, III, SECRETARY OF THE TREASURY, ON THE EFFECTIVE DATES OF PENDING TAX REFORM LEGISLATION (MARCH 14, 1986)

The following is a joint statement made by Chairman Dan Rostenkowski (D., Ill.), House Committee on Ways and Means, Chairman Bob Packwood (R., Ore.), Senate Committee on Finance, Rep. John J. Duncan, Ranking Member of the Committee on Ways and Means, Senator Russell Long, Ranking Member of the Committee on Finance, and Secretary of the Treasury James A. Baker, III, with respect to the effective dates of certain provisions of the comprehensive tax reform legislation (H.R. 3838) being considered by the Congress:

As Chairmen and ranking members of the tax-writing committees of the House and Senate and Secretary of the Treasury, we are sensitive to the uncertainty created by the pending comprehensive tax reform legislation (H.R. 3838). In undertaking tax reform, our intent is to provide greater equity in the tax system, a goal that will encourage greater confidence in our Government as a whole.

The uncertainty created by some effective dates contained in H.R. 3838, as passed by the House in December 1985, is to an extent the unavoidable result of the thoughtful, deliberative process, which is necessary if we are to achieve our ultimate goal. We have reviewed the effective dates of the major provisions of the pending tax reform legislation and have examined the consequences of any postponement of those dates.

The chief principle guiding us has been a balancing of revenue effect and possible rush to market of tax-motivated transactions against any adverse effects created by the effective dates in H.R. 3838. At this time, we have determined that tax-exempt financing for State and local governments is an area where we support a selective postponement of effective dates. In taking this action, we are making no commitment with respect to what substantive rules ultimately may be enacted governing tax-exempt bonds.

Many Members of Congress are concerned about recent dramatic increases in the volume of tax-exempt refinancings for private activities. It is not our intent, however, to restrict the ability of States and local governments to finance their direct governmental operations or to force States to change their existing practices governing financing of those operations while tax reform legislation is pending.

Therefore, we are endorsing a postponement, until September 1, 1986 (or the date of enactment of tax reform legislation, if earlier) of any application of the provisions and restrictions listed below to bonds that under present law are not (i) industrial development bonds, (ii) bonds that would be IDBs if section 501(c)(3) organizations were nonexempt persons engaged in trades or businesses, (iii) student loan bonds, (iv) mortgage subsidy bonds, or (v) other private ("consumer") loan bonds for which tax-exemption is permitted. In addition, this action does not apply to so-called pension bonds or to bonds which involve payments by private parties for the use of bond-financed property and which would be IDBs if such payments were used to pay debt service.

The provisions and restrictions to which this action applies are—

(1) The definition of nonessential function bond and the new unified volume cap contained in H.R. 3838;

(2) Any extension of arbitrage rebate restrictions, and any other new arbitrage restrictions, other than the method of determining bond yield (*i.e.*, the reversal of the decision in *State of Washington v. Commissioner*);

(3) Any new restrictions on early issuance of these bonds (*i.e.*, provisions requiring certain expenditures within certain periods);

(4) Any new restrictions on advance refunding of bonds which were originally issued before 1986, other than a limitation on the temporary period for refunding bond proceeds to 30 days and the method of determining bond yield (listed in item (2), above);

(5) Any extension of information reporting requirements to these bonds; and

(6) Any treatment of interest on these bonds as a minimum tax preference item under H.R. 3838 as passed by the House.

We believe that limiting our action to the bonds described and provisions listed above does not threaten a rush to market of tax-motivated transactions. However, we are instructing our staffs to monitor the tax-exempt bond market as consideration of tax reform legislation continues, and to advise us of any indications of evidence of tax-motivated bond issuance.

We believe our action today is consistent with the goal of comprehensive tax reform and will enable the Congress better to act only after thorough consideration of the many issues presented by such reform.

APPENDIX XIII-2

JOINT STATEMENT BY THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, THE HONORABLE BOB PACKWOOD (R., ORE.), CHAIRMAN, COMMITTEE ON FINANCE, AND THE HONORABLE JAMES A. BAKER, III, SECRETARY OF THE TREASURY, (JULY 17, 1986)

The following is a joint statement made by Chairman Dan Rostenkowski (D., Ill.), House Committee on Ways and Means, Chairman Bob Packwood (R., Ore.), Senate Committee on Finance, and Secretary of the Treasury James A. Baker, III, with respect to the effective date of a proposed requirement that certain arbitrage profits on tax-exempt bonds be rebated to the Federal Government:

On March 14, 1986, we issued a joint statement indicating our intention that certain new restrictions on tax-exempt bonds contained in tax reform legislation (H.R. 3838), as passed by the House of Representatives and the Senate, not be applied to bonds used to finance operations of State and local governments that are issued before the earlier of the date of enactment of H.R. 3838, or September 1, 1986.

As we stated in March, it is not our intent to restrict the ability of State and local governments to finance their direct governmental operations or to force States to change their existing practices governing financing of those operations while tax reform legislation is pending. As we also stated, however, we did not intend by our statement to create an atmosphere where tax-motivated issuance of bonds would occur. To that end, we instructed our staffs in that statement to monitor the tax-exempt bond market as consideration of tax reform legislation continued, and to advise us of any indications of tax-motivated bond issuance.

During the past week, Congressional and Treasury staffs have informed us of a substantial increase in volume of transactions that are motivated primarily by the ability to earn and retain arbitrage profits. These arbitrage-motivated transactions were never intended to be covered by our joint statement in March. The arbitrage-motivated transactions to which we are referring involve the funding of so-called "blind pools" with tax-exempt bonds. Issuance of tax-exempt bonds for the pools in question generally has not occurred before 1986, or has occurred in much smaller amounts than in 1986. In addition, there are few or no binding commitments as to the ultimate users of the proceeds of the bonds in question, and the bonds are being issued for longer terms than is customary for such issues.

After reviewing these transactions, we have determined that issuance of bonds for these arbitrage-motivated pools is not within the spirit of our statement of March 14, 1986. We are announcing, therefore, that the provisions of that statement relating to rebate of certain arbitrage profits are not applicable to bonds issued after 3:00 P.M., E.D.T., Thursday, July 17, 1986, for—

(1) Pools the proceeds of which are to be used to make loans to governmental units other than subordinate governmental units within the jurisdiction of the issuer (or the jurisdiction of the governmental unit on behalf of which the issuer acts); or

(2) Pools with respect to which—

(a) Less than 75 percent of the proceeds of the issue is to be used to make loans to initial borrowers to finance projects identified (with specificity) by the issuer on the date of issue as projects to be financed with the proceeds of such issue; or

(b) On or before the date of issue, commitments have not been entered into by such initial borrowers to borrow at least 25 percent of the proceeds of such issue.

Paragraph (2) applies only if bonds were not issued by the issuer before 1986 to fund similar pools, or, if the issuer had established a pool before 1986, the issuance in 1986 exceeds 250 percent of the average annual issuance for such pools during the period 1983 through 1985; or

(3) Pools where the term of the bonds exceeds 30 years if the principal repayments on any loans are to be used to make or finance additional loans.

For purposes of this announcement, an issue of bonds sold to a securities firm, broker, or other person acting in the capacity of an underwriter or wholesaler is not treated as issued before such bonds have been re-offered to the public (pursuant to final offering materials) and at least 25 percent of such bonds actually have been sold to the public.

This statement is not intended to address the issue of whether interest on these bonds is tax-exempt under present law or whether such bonds qualify for temporary periods when unlimited arbitrage profits may be earned. That determination must be made on a case-by-case basis by the Treasury Department.

We believe that this limited action will permit continued access to tax-exempt financing for actual needs of States and local governments while preventing a further rush to market of tax-motivated transactions. We are, however, instructing our staffs to continue to monitor the tax-exempt bond market as the conference committee meets and to report to us any evidence of further tax-motivated transactions.

TITLE XIV—TRUSTS AND ESTATES; MINOR CHILDREN; GIFT AND ESTATE TAXES; GENERATION-SKIPPING TRANSFER TAX

A. Income Taxation of Trusts and Estates [1]

1. Rate schedule of trusts and estates (Sec. 101 of the Act and sec. 1 of the Code)

Prior Law

In general

Under both present and prior law, the income taxation of a trust depends on whether the trust is a grantor or nongrantor trust. In the case of a grantor trust (i.e., one where the grantor (or other person with the power to revoke the trust) has certain powers with respect to the trust), income is taxed directly to the grantor. In the case of a nongrantor trust, each trust is treated as a separate taxable entity.

Nongrantor trusts

Under both present and prior law, trusts and estates generally are treated as conduits with respect to amounts that are distributed currently and taxed as individuals with respect to amounts retained in the trust or estate. The conduit treatment is achieved by allowing the trust or estate a deduction for amounts that are distributed to beneficiaries during the taxable year to the extent of the distributable net income of the trust or estate for that taxable year. Such distributions are includible in the gross income of the beneficiaries to the extent of the distributable net income of the trust or estate. In general, the character in the hands of the beneficiary of amounts distributed by a trust or estate is the same as it was in the hands of the trust or estate.

When a trust distributes previously accumulated income to a beneficiary, the tax on that distribution is determined by special averaging rules. Under those rules (called the "accumulation distribution" or "throwback" rules), such income is taxed at the average of the top tax rates of the beneficiary during three of the previous five years, excluding the highest and lowest years.

Exemptions and deductions

Estates are entitled to a deduction, in lieu of a personal exemption, of $600. Trusts which are required to distribute all of their income currently are entitled to a deduction of $300. All other trusts are entitled to a deduction of $100. No zero bracket amount or standard deduction is permitted. An unlimited charitable deduction is available.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1211; H.Rep. 99-426, pp. 804-19; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 101, 1611-14; S.Rep. 99-313, pp. 866-74; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 763-66 (Conference Report).

Tax rates

Under prior law, trusts and estates generally were taxed at the same rates as a married person filing a separate return. Under both present and prior law, in the case of gain derived from the sale or exchange of property contributed to the trust within the preceding two years, that portion of the gain attributable to the difference between the fair market value of the property at the time it was contributed to the trust and the grantor's basis in the property is taxed at the grantor's marginal tax rates.

Taxation of distributions to beneficiaries

Under both present and prior law, distributions to beneficiaries are taxed to beneficiaries and deductible by the trust to the extent of the distributable net income (DNI) of the trust. DNI is allocated first to distributions that are required to be made out of income for the year, secondly to distributions made to charity out of trust income, and lastly to other distributions.

Accumulation distributions

Special rules (referred to as the so-called "accumulation distribution" or "throwback" rules) apply to the taxation of beneficiaries of a trust where the trust distributes amounts of income (other than capital gain) that had previously been taxed to the trust. Under these rules, the income is first increased (grossed up) by the taxes previously paid by the trust on the distributed income. The grossed-up income is then included in the gross income of the beneficiary. A tax is then computed on the grossed-up amount by using the average top marginal rate of the beneficiary during three of the five preceding taxable years, excluding the two taxable years with the highest and lowest incomes. In determining the amount of this tax, all of the distribution is treated as ordinary income, other than distributed income that was tax-exempt income to the trust. Finally, the amount of the tax on the distribution of the previously accumulated income is the amount of this tax reduced (but not below zero) by the amount of taxes previously paid on the distributed income by the trust.

The accumulation distribution rules do not apply to distributions by estates. The accumulation distribution rules generally do not apply if the income was accumulated while the beneficiary was a minor. However, this exclusion from the accumulation distribution rules does not apply if distributions had been made of income from two other trusts, which income also had been accumulated in that same year.

In addition, if distributions from two other trusts previously had been made of income that was accumulated in the same year as the present distribution of accumulated income, the gross-up and credit otherwise provided for the taxes previously paid by the trust on the distributed income is not allowed.

In the case of distributions by a foreign trust of previously accumulated income, the exemption from the accumulation distribution rules for amounts accumulated while the beneficiary was a minor does not apply. In addition, any tax on distributions of previously accumulated income is increased by an interest charge computed at 6 percent for each year from the time the income was earned until it was distributed.

Multiple trusts

Under both present and prior law, two or more trusts are treated as one trust for Federal income tax purposes if (1) those trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and (2) a principal purpose of such trusts is the avoidance of Federal income tax.

Reasons for Change

The prior rules relating to the taxation of trusts and estates permit the reduction of taxation through the creation of entities that are taxed separately from the beneficiaries or grantor of the trust or estate. This result arises because any retained income of a trust or estate was taxed to the trust or estate under a separate set of rate brackets and exemptions from those of its grantor and beneficiaries.

Moreover, the present accumulation distribution rules are not adequate to prevent the avoidance of tax through the use of trusts and estates. In the case of estates, distributions of previously accumulated income are not subject to the accumulation distribution rules and are not taxed to their beneficiaries. In the case of trusts, the accumulation distribution rules permit the deferral of taxation without any interest accruing on the deferred taxes. Moreover, the corrective effect of the accumulation distribution rules can be mitigated by making the distribution of previously accumulated income during years that the beneficiaries are in low tax brackets.

The Congress believed that the tax benefits which result from the ability to split income between a trust or estate and its beneficiaries should be eliminated or significantly reduced. On the other hand, the Congress believed that significant changes in the taxation of trusts and estates are unnecessary to accomplish this result. Accordingly, the Act attempts to reduce the benefits arising from the use of trusts and estates by revising the rate schedule applicable to trusts and estates so that retained income of the trust or estate will not benefit significantly from a progressive tax rate schedule that might otherwise apply. This is accomplished by reducing the amount of income that must be accumulated by a trust or estate before that income is taxed at the top marginal rate. The Congress believed that these changes will significantly reduce the tax benefits inherent in the prior law rules of taxing trusts and estates while still retaining the existing structure of taxing these entities.

Explanation of Provision

The Act revises the tax rate schedule applicable to trusts and estates. Under the revised rates, the first $5,000 of taxable income of trusts and estates is taxed at 15 percent. Any taxable income of trusts and estates in excess of $5,000 is taxed at 28 percent. In addition, the benefit of the 15 percent bracket is phased-out where the taxable income of the trust or estate is between $13,000 and $26,000.

An additional rate schedule [2] is provided for taxable years beginning in 1987.

Effective Date

The provision applies to taxable years of both new and existing trusts and estates beginning after December 31, 1986. For 1987 returns, a blended rate schedule based upon the present law rates and new rates would apply.

Revenue Effect

The revenue effect of this provision is included with item 2, below.

2. Revision of grantor trust rules (Secs. 1411 and 1412 of the Act and secs. 672, 673, 674, 676, and 677 of the Code)

Prior Law

Overview

Where the grantor transfers property to a trust and retains certain powers or interests over the trust, the grantor is treated, under both present and prior law, as the owner of that trust for Federal income tax purposes under the so-called "grantor trust provisions." As a result, the income and deductions attributable to that trust are included directly in the grantor's taxable income. In addition, a beneficiary is treated as the owner of a trust where the beneficiary has given up a power to revoke the trust but retains any of such powers or interests in the trust.

Reversionary interests

Under prior law, a grantor is treated as the owner of that portion of a trust in which he has a reversionary interest in corpus or income therefrom if the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years of the transfer to the trust. An exception was provided under which a grantor was not treated as having such a reversionary interest if the possession or enjoyment did not take effect until the death of the income beneficiary of that portion of the trust.

Power to control beneficial enjoyment

Under both present and prior law, a grantor is treated as the owner of any portion of a trust over which the grantor, or a nonadverse party, without the consent of an adverse party, has the power to control the beneficial enjoyment of the corpus or income from

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[2] The income tax schedule for estates and trusts for 1987 would be as follows:

If taxable income is—	The tax is—
Not over $500	11% of taxable income
Over $500 but not over $4,700	$55 plus 15% of the excess over $500
Over $4,700 but not over $7,550	$685 plus 28% of the excess over $4,700
Over $7,550 but not over $15,150	$1,483 plus 35% of the excess over $7,550
Over $15,150	$4,143 plus 38.5% of the excess over $15,150

that portion of the trust. Prior law provided the following exceptions to this rule:

(1) the power to apply the income for the support of a dependent to the extent that the power was is not used to apply the income for the support of the dependent;

(2) any power to control beneficial enjoyment of the principal or income that takes effect only after 10 years from the transfer to the trust or after the death of the income beneficiary;

(3) a power exercisable solely by will other than powers which affect accumulated income in the trust;

(4) a power to allocate income of corpus among charitable beneficiaries;

(5) a power to distribute corpus (a) to beneficiaries within a fixed class of beneficiaries which is subject to a reasonably definite standard or (b) to income beneficiaries where the corpus distribution was an advancement of that beneficiary's proportionate share of the trust;

(6) a power to withhold income temporarily from a beneficiary within a fixed class of beneficiaries where the withheld income must have been distributed to that beneficiary or his estate or the beneficiary had a general power of appointment over that property;

(7) a power to withhold income during the disability of a beneficiary within a fixed class of beneficiaries;

(8) a power to allocate items between income and corpus;

(9) a power held by an independent trustee to spray income and corpus among a fixed class of beneficiaries; and

(10) a power to allocate income or corpus to beneficiaries within a fixed class of beneficiaries that was subject to a reasonably definite external standard.

Administrative powers

Under both present and prior law, a grantor is treated as the owner of a portion of the trust with respect to which—

(1) the grantor or a nonadverse party has the power to deal with the trust for less than adequate and full consideration;

(2) the grantor or a nonadverse party has a power which enables the grantor to borrow trust income or corpus without adequate interest or without adequate security;

(3) the grantor has borrowed income or corpus of the trust and has not repaid that amount before the beginning of the taxable year, unless the loan provides for adequate interest and security and is made by an independent trustee; and

(4) the grantor has retained the power exercisable in a nonfiduciary capacity (a) to vote stock of a corporation in which the holdings of the trust and the grantor are significant from a viewpoint of voting control, (b) to control the investments of the trust in such corporations, or (c) to reacquire trust corpus by substituting other property of equivalent value.

Power to revoke

Under prior law, the grantor was treated as the owner of a portion of a trust where the grantor had the power to revest the title to that portion in the grantor, other than a power that cannot affect the beneficial enjoyment of the property until after 10 years from the transfer to the trust or after the death of the income beneficiary.

Income for benefit of grantor

Under both present and prior law, the grantor is treated as the owner of a portion of a trust if the income from that portion is, or in the discretion of the grantor or a nonadverse party may be, (1) distributed to the grantor or the grantor's spouse, (2) held for future distribution to the grantor or the grantor's spouse, or (3) applied to the payment of premiums on life insurance on the life of the grantor or the grantor's spouse. Prior law provided an exception if the power could have been exercised only after 10 years from the transfer to the trust or the death of the income beneficiary and if the power could have been used to apply corpus or income of the trust to discharge the grantor's obligation of support of a dependent, unless the power was so exercised.

Foreign trusts having United States beneficiaries

Under both present and prior law, a grantor who is a United States person is treated as the owner of any foreign trust for any year that the trust has a United States person as a beneficiary.

Alimony trusts

Present and prior law provides another exception to the grantor trust rules in the case of certain alimony trusts. Under those rules, the income of the trust will be taxable to the grantor's former spouse, and not the grantor, if the income of the trust is payable to the former spouse of the grantor pursuant to a written separation agreement or under a decree of divorce. This exception does not apply with respect to amounts paid by the trust for the support of minor children.

Reasons for Change

While the Congress believed that there are many nontax reasons for the creation of trusts, the Congress was concerned about the tax benefits arising under the grantor trust rules of present law. The prior rules relating to grantor trusts permitted the taxation of the stream of income from assets to be separated from the ownership of those assets. This was particularly true of trusts which took advantage of the so-called "10-year rule" which resulted in nonapplication of the grantor trust provisions where certain powers and interests which were retained by the grantor did not become effective in the grantor for a period of 10 years. In addition, many tax practitioners took the position that the application of the prior law grantor trust provisions could be avoided by having the prohibited powers or interests become effective in the spouse of the grantor (e.g., the spousal remainder trust).

In order to reduce the tax benefits arising from the use of trusts, the Congress believed that the so-called "10-year rule" should be repealed so that a trust would be treated as a grantor trust in all cases were there is any significant possibility that interests and powers in the trust may become effective in the grantor after the creation of the trust. Moreover, the Congress believed that interests and powers of spouses of the grantor should be treated as held by the grantor for purposes of the grantor trust rules.

Explanation of Provision

The Act repeals the 10-year exception of present law and replaces that rule with a rule that treats a trust as a grantor trust where there is more than a 5 percent possibility that any of the proscribed powers or interests will become effective in the grantor after the transfer of property to the trust. For this purpose, the possibility that an interest may return to the grantor or his spouse solely under intestacy laws is to be ignored under this provision.

In order to ease administration of this rule, the Act provides an exception under which the grantor is deemed not to have retained a proscribed power or interest if that interest or power can become effective in the grantor only after the death of a lineal descendant of the grantor who also is a beneficiary of that portion of the trust. In order for this rule to apply to all or a portion of a trust, the beneficiary whose life is used must have the entire present interest (as defined in sec. 2503(c)) in that trust or trust portion.

The Act also provides that, for purposes of the grantor trust provisions, the grantor is treated as holding any power or interest held by the grantor's spouse if that spouse is living with the grantor. For this purpose, a person is treated as a spouse of the grantor who is living with the grantor if that person and the grantor are eligible to file a joint return with respect to the period in which the transfer is made. The status of a person holding a power or interest as a spouse of the grantor with whom the grantor is living is to be determined at the time of the transfer of the property to the trust.

Effective Date

The provision applies to transfers in trusts made after March 1, 1986. The Act provides an exception under which the 10-year rule of present law would continue to apply to certain trusts created pursuant to binding property settlements entered into before March 1, 1986, which required the creation of a trust and the transfer to the trust of property by the grantor.

Revenue Effect

The provisions revising the rate schedule and grantor trust rules are estimated to increase fiscal year budget receipts by $69 million in 1987, $217 million in 1988, $234 million in 1989, $253 million in 1990, and $275 in 1991.

3. Taxable years of trusts (Sec. 1413 of the Act and sec. 645 of the Code)

Prior Law

Under both present and prior law, trusts generally are treated as conduits with respect to amounts that are distributed currently and taxed as individuals with respect amounts retained in the trust. The conduit treatment is achieved by allowing the trust a deduction for amounts that are distributed to beneficiaries during the taxable year to the extent of the distributable net income of the trust for that taxable year. Such distributions are includible in the gross income of the beneficiaries to the extent of the distributable net income of the trust. Where the trust and the beneficiaries have different taxable years, the amounts includible in the gross income of the beneficiaries are determined by reference to income of the trust for its taxable year ending with or within the taxable year of the beneficiary.

Reasons for Change

In the case where the trust has a taxable year different than the taxable year of its beneficiaries, the present and prior law rules governing the taxation of trusts permit the deferral of taxation by one month for each month that the taxable year of the trust ends sooner than the taxable year of its beneficiaries. Thus, in the case of a taxable year of a trust ending on January 31 and the trust beneficiary on a calendar year, the taxation of trust income which is distributed to the beneficiary is deferred eleven months.

The Congress believed that the ability to defer taxation on income through the selection of taxable years of trusts should be limited.[3] Accordingly, the Act requires all trusts to have a calendar year as its taxable year. Where the beneficiaries of the trust use a calendar year for their taxable year (which is typically the case), this rule will eliminate any deferral of taxation of income.

Explanation of Provision

The Act requires that all trusts (both existing and newly created) adopt a calendar year as its taxable year. However, the Act provides an exception under which tax-exempt trusts (described in sec. 501) and wholly charitable trusts (described in sec. 4947(a)(1)) are not required to adopt a calendar year.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986. Thus, in the case of a trust with a taxable year ending on January 31, the trust must adopt a taxable year beginning on February 1, 1987, and ending on December 31, 1987. Consequently, the trust will have a short taxable year (i.e., a taxable year of less than 12 months) in 1987.

In order to alleviate the bunching of taxable income arising from the change in taxable years, the Act provides that the taxable income to the beneficiary attributable to any short taxable year required under the Act is to be spread over a four year period beginning with the year of change. Thus, in the above example, if the amount includible in the income of a beneficiary for the short year is $4,000, the beneficiary would include $1,000 in income in his taxable years 1987, 1988, 1989, and 1990.[4]

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[3] Under both present and prior law, a decedent's estate is treated as a separate taxable entity, beginning as of the date of death. The estate may elect a taxable year different than the decedent's taxable year. The Congress recognized that the same possibilities of deferral also are present in the case of estates. Nonetheless, the duration of estates generally is much shorter than the duration of trusts and there often is a greater need for executors of estates to select an accounting period that coincides with the administration of the estate. The Act does not, therefore, affect the present law treatment of the taxable years of estates.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $747 million in 1987, $83 million in 1988, $86 million in 1989, $88 million in 1990, and $90 million in 1991.

4. Requirement that trusts and estates make estimated payments of income tax (Sec. 1414 of the Act and secs. 6152 and 6654 of the Code)

Prior Law

Under prior law, trusts and estates were not required to make estimated tax payments (sec. 6654(k)). Trusts were required to pay their income tax at the time of filing of the income tax return (sec. 6151). Moreover, estates could have elected to pay their income tax in four equal installments beginning with the due date of the return and for each 3 month period thereafter (sec. 6152).

Reasons for Change

The Congress believed that trusts and estates should pay tax in the same manner as is required of individuals.

Explanation of Provision

The Act provides that both new and existing trusts and estates pay estimated tax in the same manner as individuals. In addition, the Act repeals the rules that permit estates to pay their tax over four equal installments.

In addition, the Act provides that, in the case of trusts making estimated payments, the trustee may elect to assign any amount of its quarterly payments to a beneficiary or beneficiaries. Such an election must be made on the income tax return of the trust which is filed within 65 days after the end of the trust's taxable year. If the trustee makes such an election, the amount of credits assigned to beneficiaries is considered a distribution under the 65-day rule of section 663. Thus, the beneficiary to whom the credit is assigned is deemed to receive a distribution on the last day of the trust's year for Federal income tax purposes. Nonetheless, the beneficiary treats the credit as received on the date the election is made for purposes of the beneficiary's estimated taxes.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

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[4] This spreading of the inclusion of income applies to distributions of distributable net income of the trust. It does not apply to any accumulation distributions occurring during the short taxable year.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $830 million in 1987, $356 million in 1988, $78 million in 1989, $79 million in 1990, and $81 million in 1991.

B. Unearned Income of Certain Minor Children

(Sec. 1411 of the Act and sec. 1 of the Code)[5]

Prior Law

Under both present and prior law, if income-producing assets are transferred to a minor child, income earned on those assets generally is taxed to the child. Under prior law, that income was taxed at the child's rate.

Reasons for Change

The Congress believed that the prior law rules governing the taxation of minor children provided inappropriate tax incentives to shift income-producing assets among family members. In particular, the Congress was aware that the treatment of a child as a separate taxpayer encouraged parents whose income would otherwise be taxed at a high marginal rate bracket to transfer income-producing property to a child to ensure that the income was taxed at the child's lower marginal rates. In order to reduce the opportunities for tax avoidance through transfers of income producing property to minor children, the Congress concluded that it generally is appropriate to tax the unearned income of a minor child under age 14 at the parent's marginal rates.

Explanation of Provision

The net unearned income of a child under 14 years of age is taxed to the child at the top rate of the parents. The provision applies with respect to a child under 14 years of age who has at least one living parent as of the close of the taxable year. The tax payable by a child on the net unearned income is equal to the additional amount of tax that the parent would be required to pay if the child's net unearned income were included in the parent's taxable income. The provision applies to all net unearned income of a child under 14 years of age regardless of the source of the assets creating the child's net unearned income.

Net unearned income means unearned income less the sum of $500 and the greater of: (1) $500 of the standard deduction or $500 of itemized deductions or (2) the amount of allowable deductions which are directly connected with the production of the unearned income. The $500 figures are to be adjusted for inflation beginning in 1989. The Congress expected that the Treasury Department will issue regulations providing for the application of these provisions where either the child or the parent is subject to the alternative minimum tax for the year. In addition, where the tax on capital gains of a trust is determined by reference to that income of the parent (under sec. 644) and the tax on the income of that parent's child also is determined by reference to the income of that parent, the Congress intended that the tax of the trust be determined before the tax of the child is determined.

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[5] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1201; H.Rep. 99-426, pp. 800-03; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1601; S.Rep. 99-313, pp. 862-5; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 767-69 (Conference Report).

The following examples illustrate the tax consequences of this provision to a dependent child under age 14 in 1988.

Example 1.—If the child has $400 of unearned income and no earned income, the child's standard deduction is $400 which is allocated against the child's unearned income, so that the child has no Federal income tax liability.

Example 2.—If the child has $900 of unearned income and no earned income, the child's standard deduction is $500 which is allocated against the first $500 of unearned income. The child's remaining unearned income is $400. Because the child's net unearned income is less than $500, the remaining unearned income is taxed at the child's rates.

Example 3.—If the child has $1,300 of unearned income and no earned income, the child's standard deduction is $500 which is allocated against unearned income. The child's remaining unearned income is equal to $800 of which the first $500 is taxed at the child's rates, and the remaining $300 of unearned income is taxed at the top rate of the parents.

Example 4.—If the child has $700 of earned income and $300 of unearned income, the child's standard deduction is $700 of which $300 is allocated against unearned income and $400 is allocated against earned income. The child has no net unearned income and the remaining $300 of earned income is taxed at the child's rates.

Example 5.—If the child has $800 of earned income and $900 of unearned income, the child's standard deduction is $800 of which $500 is allocated against unearned income and $300 is allocated against earned income. The child's remaining unearned income is $400. Because net unearned income is less than $500, the child's remaining unearned income is taxed at the child's rates. The remaining $500 of earned income also is taxed at the child's rates.

Example 6.—Assume the child has $300 of earned income and $1,200 of unearned income, and itemized deductions of $400 (net of the 2-percent floor) which are directly connected with the production of the unearned income. The child has $400 of other deductions. Because of the deductions directly connected with the production of the unearned income ($400) are less than the maximum amount of deductions ($500) which are allocated against unearned income, $500 of the $800 total deductions are allocated against unearned income. Therefore, the child's remaining unearned income is $700 ($1,200 of unearned income less $500) of which $500 is taxed at the child's rates and $200 is taxed at the parents' rate.

Example 7.—Assume the child has $700 of earned income and $3,000 of unearned income, and itemized deductions of $800 (net of the 2-percent floor) which are directly connected with the production of the unearned income. The child has $200 of other deductions. The entire amount of deductions relating to the production of unearned income is allocated against his unearned income, because this amount ($800) exceeds $500. Therefore, the child's remaining unearned income is equal to $2,200 ($3,000 of unearned income less $800) of which $500 is taxed at the child's rates and $1,700 at the parents' top rate. The child has $200 of deductions which is allocated against earned income. The remaining $500 of earned income is taxed at the child's rates.

Effective Date

The provision is effective for taxable years beginning after the date of enactment (October 22, 1986).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $60 million in 1987, $195 million in 1988, $226 million in 1989, $249 million in 1990, and $274 million in 1991.

C. Gift and Estate Taxes

1. Filing estate tax current use valuation elections (sec. 1421 of the Act and sec. 2032A of the Code)[6]

Prior Law

Under both present and prior law, real property used in certain farming and other closely held business activities may be valued at its current use, rather than fair market, value for estate tax purposes. This provision is available only if it is elected on the first estate tax return filed, and only if the election, as filed, substantially complies with the requirements of Treasury Department Regulations concerning information to be supplied when making the election and execution of an agreement by all parties having an interest in the specially valued property.

Reasons for Change

Congress was concerned that, in certain cases, the Federal estate tax return (Form 706) provided by the Treasury Department for filing estate tax returns did not sufficiently inform taxpayers of what information must be provided to elect current use valuation and that an agreement to the election is required to be attached to Form 706. Congress determined, therefore, that limited relief permitting taxpayers additional time to supply information is appropriate where taxpayers could have been misled by an absence of information on Form 706.

Explanation of Provision

The Act provides that estates of individuals dying before January 1, 1986, that substantially complied with the requirements enumerated on the Federal Estate Tax Return (as opposed to in Treasury Department regulations or instructions to the return) are allowed to perfect defective elections within 90 days of being notified of errors by the Treasury.[7] Specifically, the June 1982 edition of Form 706, Federal Estate Tax Return, did not specify on the face of the return that an agreement by parties with an interest in specially valued property had to be submitted with the return.[8] This provision, therefore, permits late filing of the required agreements for estates that used that edition of Form 706.

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[6] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1615; S.Rep. 99-313, pp. 876-7; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 770-71 (Conference Report).

[7] This provision applies only to estates of individuals where attempted elections were timely (within the meaning of sec. 2032A(d)(1)).

[8] The absence of a direction that an agreement is required under sec. 2032A(d) was corrected on the January 1984 edition of Form 706.

In addition, the Act adds a targeted transitional exception for the estate of an individual who died on January 30, 1984, and for whose estate the Federal estate tax return was filed on October 30, 1984.

Effective Date

This provision is effective on the date of enactment (October 22, 1986).

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

2. Gift and estate tax deductions for certain conservation easements (Sec. 1422 of the Act and secs. 2055 and 2522 of the Code)[9]

Prior Law

Under both present and prior law, a special exception to the general restrictions on tax deductions for charitable contributions of partial interests in property applies in the case of qualified conservation contributions (e.g., easements). (In general, gifts of less than the entire interest in property held by the donor are nondeductible.) Under prior law, in order to qualify for a gift or estate tax deduction, qualified conservation contributions had to satisfy the same requirements, including the conservation purpose requirement, that apply for income tax deductions.

Reasons for Change

Congress was concerned that applying the same conservation purpose standards for income, gift, and estate tax deductions may cause undesirable results in certain cases. For example, under prior law, if a conservation contribution was made and it later was established that the conservation purpose requirement for the contribution to be deductible was not satisfied, the donor lost his or her income tax deduction, and also could be subject to gift or estate tax. This was true notwithstanding the fact that a charitable organization owned the property interest and the donor might not have other property or funds with which to pay the gift or estate tax.

Explanation of Provision

The Act permits gift or estate tax deductions to be claimed for qualified conservation contributions without regard to whether the contributions satisfy the income tax conservation purpose requirement.

In addition, the Act provides a targeted transitional exception deeming certain conservation contributions to the Acadia National Park in Maine to satisfy the conservation purpose requirement.

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[9] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 717; S.Rep. 99-313, pp. 283-84; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 771-72 (Conference Report).

Effective date

This provision applies to transfers occurring after December 31, 1986.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

3. Special rule for estate of James H. W. Thompson (Sec. 1423 of the Act)[10]

Prior Law

Under both present and prior law, gift and estate tax deductions are permitted for charitable contributions only if property with respect to which deductions are claimed is transferred directly to a qualified organization and certain other requirements are satisfied.

Reasons for Change

Congress determined that extraordinary circumstances resulting from restrictions imposed by a foreign government on property located in that country warranted an exception to the general rule that estate tax charitable deduction is allowed only for property passing directly from a decedent to a charitable organization. In making this special exception, however, Congress did not intend to create a precedent or to imply that other exceptions such as this will be enacted in the future.

Explanation of Provision

The Act allows an estate tax deduction for certain property transferred by James H. W. Thompson to his nephew who then transferred the property to a charitable foundation pursuant to his uncle's instructions. This property is treated as if it passed directly from Thompson to the charitable foundation.

Effective Date

This provision was effective on October 22, 1986.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million.

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[10] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1618; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 772-73 (Conference Report).

D. Generation-Skipping Transfer Tax (Secs. 1431-33 of the Act and chapter 13 of the Code)[11]

Prior Law

Overview

A generation-skipping trust was defined as a trust which provided for the splitting of benefits between two or more generations that were younger than the generation of the grantor. A generation-skipping transfer tax, substantially equivalent to the estate tax that would have been imposed on direct transfers to each generation, was imposed on certain distributions from, and terminations of interests in or powers over, such trusts.

The tax was imposed when trust assets were distributed to a generation-skipping beneficiary or upon the termination of an intervening interest in the trust. No tax was imposed on outright transfers to generation-skipping beneficiaries.

No tax was imposed if the younger generation beneficiary had (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor.

In addition, prior law provided an exclusion for the first $250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

Imposition of tax

A generation-skipping transfer was defined as a transfer to a beneficiary at least two generations younger than the transferor. Generation-skipping transfers were subject to tax if made under a trust or similar arrangement. No tax was imposed in the case of outright transfers to generation-skipping beneficiaries.

Taxable events

A generation-skipping transfer tax was imposed on the occurrence of either a taxable termination or a taxable distribution.

A taxable termination meant the termination of an interest or power of a younger generation beneficiary who was a member of a generation older than that of any other younger generation beneficiary of the trust. Such a termination generally occurred by reason of death (in the case of a life interest) or by lapse of time (in the case where the grantor created an estate for years).

For example, if a trust provided income for life to the grantor's child, with remainder to the grantor's grandchild, there was a taxable termination of the child's interest upon his or her death because this death terminated the interest (in this case, a life income interest) of a younger generation beneficiary (the child) who was a member of a generation older than that of any other younger generation beneficiary (the grandchild) of the trust. For purposes of determining whether there had been a generation-skipping transfer, the determination as to whether there were younger generation beneficiaries was made immediately before the transfer took place.

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[11] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, secs. 1221-23; H.Rep. 99-426, pp. 820-28; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 774-76 (Conference Report).

Special rules postponed the taxable termination (and thus the imposition of the tax) in cases involving future interests or powers, multiple beneficiaries, and discretionary interests.

A taxable distribution occurred whenever there was a distribution from a generation-skipping trust, other than a distribution out of accounting income (sec. 643(b)) to a younger generation beneficiary of the trust, and there was at least one other younger generation beneficiary who was a member of an older generation than the distributee. For example, assume that a discretionary trust was established for the benefit of the grantor's child and grandchild. The trustee exercised its discretion by distributing accounting income to the child and also made a distribution out of corpus to the grandchild. This would have constituted a taxable distribution because there would have been at least one younger generation beneficiary (the child) who was a member of a generation older than that of the grandchild.

Where there were distributions out of corpus as well as out of income, the distributions to members of the oldest generation (whether or not they are younger generation beneficiaries) were treated as having been made out of income (to the extent of the income), and the distributions to younger generations were treated as having been made out of any remaining income, and then out of corpus.

The terms taxable termination and taxable distribution did not include any amounts which were subject to gift or estate tax (for example, because the beneficiary whose interest in a trust had terminated had a general power of appointment with respect to the trust property). Where both a termination and a distribution resulted from the same occurrence (such as the death of a member of an intervening generation), the transfer was treated as a termination.

Generation assignment

A generation-skipping trust was a trust having two or more generations of "beneficiaries" who belonged to generations which were "younger" than the generation of the grantor of the trust. For purposes of the generation-skipping transfer tax provisions, a "grantor" of the trust included any person contributing or adding property to the trust.

Generally, generations were determined along family lines where possible. For example, the grantor, his or her spouse and brothers and sisters were one generation; their children (including adopted children) were the first younger generation; the grandchildren constituted the second younger generation, and so forth. Spouses of family members were assigned to the same generation as the family member to whom they are married.

Where generation-skipping transfers were made outside the family, generations were measured from the grantor. Individuals not more than 12½ years younger than the grantor were treated as members of the grantor's generation; individuals more than 12½ years younger than the grantor, but not more than 37½ years younger, were considered members of his or her children's generation, and so forth.

Exemptions from tax

Unified credit

Because the tax was based upon the transfer tax history of the deemed transferor, a generation-skipping trust was entitled, in calculating the tax arising after the death of such deemed transferor, to any unused portion of his or her unified transfer tax credit, the credit for tax on prior transfers, the credit for State death taxes, and a deduction for certain administrative expenses.

Exemption for certain transfers to grandchildren

Prior law provided a special exemption from tax if the younger generation beneficiary had nothing more than (1) a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor. In addition, a special exclusion was provided for the first $250,000 of generation-skipping transfers per deemed transferor that vested in the grandchildren of the grantor.

Computation of tax

Rate of tax

The prior-law generation-skipping transfer tax was substantially equivalent to the tax that would have been imposed if the property actually had been transferred outright to each successive generation (in which case, the gift or estate tax would have applied). For example, assume that a trust was created for the benefit of the grantor's child during the child's life, with remainder to a grandchild. Upon the death of the child, the generation-skipping transfer tax was computed by adding the child's portion of the trust assets to the child's estate and computing the tax at the child's marginal estate tax rate. In other words, for purposes of determining the amount of the tax, the child was treated under prior law as the "deemed transferor" of the trust property. The deemed transferor's marginal estate tax rate was used for purposes of determining the tax imposed on the generation-skipping transfer. Under prior law, the applicable rate on taxable transfers after 1983 ranged from 18 percent on the first $10,000 in taxable transfers to 55 percent on transfers in excess of $3 million.

Tax base and payment of tax

In the case of a taxable distribution, the amount subject to tax was the value of the money and property distributed (determined as of the time of the distribution). The tax base included the transfer taxes paid under these rules with respect to the distribution, regardless of whether these taxes were paid by the beneficiary out of the proceeds of the distribution, or the taxes were paid by the trustee out of trust monies which are paid over directly to the Government. In the case of a taxable termination, the tax base equaled (1) the value of the trust property in which an interest has terminated and/or (2) the value of the property which was the subject of a power (where a power had terminated).

Neither the deemed transferor nor his or her estate was liable for the tax imposed under these provisions. Generally, the tax was paid out of the proceeds of the trust property. In the case of a taxable distribution, however, the distributee of the property was personally liable for the tax to the extent of the fair market value of the property which he or she received (determined as of the date of the distribution). In the case of a taxable termination, the trustee was personally liable for the tax. However, the trustee was permitted to file a request with the Internal Revenue Service for information concerning the transfer tax rate bracket of the deemed transferor. Where the transfer was to a grandchild of the grantor of the trust, the trustee could have also requested information concerning the extent to which the $250,000 exclusion of the deemed transferor had not been fully utilized. The trustee was not liable for tax to the extent that any shortfall in the payment of the tax ultimately determined to be due resulted from the trustee's reliance on the information supplied by the Internal Revenue Service, in response to either of these requests.

Credit for State taxes

Because the generation-skipping transfer tax was calculated by reference to the transfer tax history of the deemed transferor, the generation-skipping trust was entitled to any unused portion of the deemed transferor's credit for state death taxes.

No specific credit was provided with respect to the payment of state generation-skipping transfer taxes.

Coordination with other provisions

Estate tax

To the extent consistent with the specific provisions concerning generation-skipping transfers, the rules of the Code relating to the gift tax applied in cases where the deemed transferor was alive at the time of the generation-skipping transfer, and the rules relating to the estate tax applied where the generation-skipping transfer occurred at or after the death of the deemed transferor.

To the extent that transfers were subject to the generation-skipping transfer tax as a result of the death of the deemed transferor, prior law permitted utilization of the unused estate tax deductions and credits of the deemed transferor. Thus, the generation-skipping transfer tax was calculated after taking into account such items as the unified credit, the State death tax credit, the previously taxed property credit, and remaining deductions for charitable bequests and administration expenses actually paid by the trust.

The alternate valuation date was available where a taxable termination occurred as a result of the death of the deemed transferor. In this case, the election to use the alternate valuation date was made by the trustee of the generation-skipping trust (who was also the person liable for the tax under these circumstances); it was not required that the executor of the deemed transferor's estate also elect that provision.

Income tax

Where certain rights to income were subject to the tax on generation-skipping transfers, the income tax treatment of so-called "income in respect of a decedent" could have applied to this income. Thus, the recipient of this income was entitled to a deduction (in computing income tax on this income) for the generation-skipping transfer tax in the same way as that recipient is allowed a deduction for the estate tax imposed on these items (sec. 691(c)). Also, where a generation-skipping transfer which was subject to tax occurred as a result of the death of the deemed transferor, section 303 treatment, which permits certain tax-free redemptions of stock to pay estate tax, was available. The trust and the actual estate of the deemed transferor were treated separately for purposes of the section 303 qualification requirements.

Reasons for Change

The Congress believed, as it stated when the generation-skipping transfer tax originally was enacted in 1976, that the purpose of the three transfer taxes (gift, estate, and generation-skipping) was not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations. The Congress determined that the present generation-skipping transfer tax was unduly complicated. Therefore, the Congress determined that this tax should be replaced with a simplified tax, determined at a flat rate. The Act accomplishes Congress' goal of simplified administration while ensuring that transfers having a similar substantial effect will be subject to tax in a similar manner.

Explanation of Provisions

Overview

The Act amends the existing generation-skipping transfer tax, which attempted to determine the additional gift or estate tax that would have been paid if property had been transferred directly from one generation to another, to impose a simplified tax determined at a flat rate. The generation-skipping transfer tax is expanded to include direct generation-skipping transfers (e.g., a direct transfer from a grandparent to a grandchild) as well as transfers (subject to tax under the prior tax) in which benefits are "shared" by beneficiaries in more than one younger generation.

Transfers of up to $1 million per grantor are exempt from tax. Additional exemptions are provided for certain transfers that are not subject to gift tax and for direct transfers to grandchildren of the transferor before 1990 if the aggregate amount of such transfers does not exceed $2 million per grandchild.

Imposition of tax

As under prior law, a generation-skipping transfer is defined as a transfer to a beneficiary at least two generations younger than the transferor. Thus, only transfers to grandchildren or younger generations are subject to tax. Generation-skipping transfers are subject to tax whether in trust, pursuant to an arrangement similar to a trust, or outright.

In general, the Act retains the prior-law rules on generation assignment, except that lineal descendants of the grandparents of the transferor's spouse also are assigned to generations on a basis like that for such descendants of the transferor.

Taxable events

A generation-skipping transfer tax is imposed on the occurrence of any one of three events—a taxable distribution, a taxable termination, or a direct skip.

The first two events generally involve transfers that were taxable under prior law. A taxable distribution occurs upon distribution of property to a generation-skipping beneficiary (e.g., a grandchild). A taxable termination occurs upon the expiration of an interest in a trust if, after that termination, all interests in the trust are held by generation-skipping beneficiaries. Persons holding interests in property are defined to include only those persons having a current right to property (or income therefrom) or persons who are current permissible recipients of the property (or income therefrom). For example, a person having an income interest for life or a holder of a general power of appointment is treated as having an interest in property.

A direct skip occurs upon an outright transfer for the benefit of a person at least two generations below the transferor or a transfer of property to a trust for one or more such beneficiaries. As described in the Overview, an example of a direct skip is a gift from a grandparent to his or her grandchild.

Effect of disclaimers

A disclaimer that results in property passing to a person at least two generations below that of the original transferor results in imposition of the generation-skipping transfer tax. For example, if a child of a decedent makes a qualified disclaimer, and, under local law, the disclaimed property passes to the grandchildren of the decedent, a generation-skipping transfer tax is imposed on the transfer (in addition to any estate tax to which the transfer is subject). The disclaimed property, rather than the decedent's estate generally, is primarily liable for payment of the generation-skipping transfer tax.

Tax on income distributions

Unlike prior law, the Act provides that generation-skipping distributions from a trust are subject to tax whether the distributions carry out trust income or trust corpus. However, an income tax deduction is allowed to the recipient for the generation-skipping transfer tax imposed on the distribution.

Tax on trusts providing for generation-skipping transfers to more than one younger generation

A single trust may provide for transfers to more than one generation of generation-skipping beneficiaries. For example, a trust may provide for income payments to the grantor's child for life, then for such payments to the grantor's grandchild, and finally for distribution of the trust property to the grantor's great-grandchild. Were such property left outright to each such generation, the property would be subject to gift or estate tax a total of three times. Under the Act, the property likewise is subject to transfer tax a total of three times—gift or estate tax on the original transfer and generation-skipping transfer tax on the transfers to the grandchild and the great-grandchild.

Exemptions from tax

$1 million exemption

The Act provides an exemption of up to $1 million for each person making generation-skipping transfers. In the case of transfers by a married individual, the individual and his or her spouse may elect to treat the transfer as made one half by each spouse. In addition, an individual may allocate all or a portion of his or her specific exemption to property with respect to which a generation-skipping transfer will occur upon its disposition by (or on the death of) the transferor's spouse as a result of an election to treat that property as qualified terminable interest property (QTIP property). (*See* secs. 2056(b)(7) and 2523(f)). Once a transfer, or portion of a transfer, is designated as exempt, all subsequent appreciation in value of the exempt property also is exempt from generation-skipping transfer tax.

The operation of the specific exemption may be illustrated by the following example. Assume a grantor transfers $1 million in trust for the benefit of his or her children and grandchildren. If the grantor allocates $1 million of exemption to the trust, no part of the trust will ever be subject to generation-skipping transfer tax—even if the value of the trust property appreciates in subsequent years to $10 million or more. On the other hand, if the grantor allocates only $500,000 of exemption to the trust, one-half of all distributions to grandchildren will be subject to tax and one-half of the trust property will be subject to tax on termination of the children's interest. If, after creation of the trust, the grantor allocates an additional $250,000 of exemption to the trust, the exempt portion of trust will be redetermined, based upon the values of the trust property at that time. This new inclusion ratio applies to future distributions and terminations, but generally does not change the tax treatment of any past events.

Exemption for nontaxable gifts

The generation-skipping transfer tax does not apply to any inter vivos transfer which is exempt from gift tax pursuant to either the $10,000 annual exclusion or the special exclusion for certain tuition and medical expense payments.

Special exemption for certain direct skips to grandchildren

A special exemption from the generation-skipping transfer tax is provided for certain direct skips (either in trust or otherwise) to grandchildren of the grantor prior to 1990. For each grantor, this special exemption is limited to $2 million per grandchild. As is true with taxable generation-skipping transfers and taxable gifts, married individuals may elect to treat these exempt transfers as made one-half by each spouse.

Special exemption for certain other transfers to grandchildren

The Act also provides a special rule on generation assignment for grandchildren of the grantor when a grandchild's parent who is a lineal descendant of the grantor is deceased. In such a case, the grandchild and all succeeding lineal descendants of the grandchild are "moved up" a generation. Thus, transfers to such grandchild are not taxed as generation-skipping transfers.

Computation of tax

Rate of tax

The rate of tax on generation-skipping transfers is equal to the maximum gift and estate tax rate. Thus, the tax rate is 55 percent until 1988, when it is scheduled to decline to 50 percent.

Tax base and payment of tax

The tax base and method of paying the generation-skipping transfer tax generally parallels the method applicable to the most closely analogous transfer subject to gift or estate tax. Generation-skipping transfers, therefore, are taxed as follows:

Taxable distributions.—The amount subject to tax is the amount received by the transferee (i.e., the tax is imposed on a "tax-inclusive" basis). The transferee pays the tax on a taxable distribution. (If a trustee pays any amount of the tax, the trustee is treated as making an additional taxable distribution of that amount.)

Taxable terminations.—The amount subject to tax is the value of the property in which the interest terminates (i.e., the tax is imposed on a "tax-inclusive" basis). The trustee pays the tax on a taxable termination.

Direct skips.—The amount subject to tax is the value (net of tax) of the property received by the transferee (i.e., the tax is imposed on a "tax-exclusive" basis). The person making the transfer pays the tax on a direct skip.

Credit for State taxes

A credit not exceeding five percent of the amended Federal generation skipping transfer tax is allowed for generation-skipping transfer tax imposed by a State with respect to taxable transfers occurring by reason of death.

Coordination with other provisions

The Act also includes several provisions coordinating the generation-skipping transfer tax with the gift and estate taxes. The Code provisions governing administration of the gift and estate taxes also apply to the amended generation-skipping transfer tax. Estate tax rules apply to generation-skipping transfers occurring as a result of death, and gift tax rules apply in other cases.

In addition to any adjustment to basis received under the gift or estate tax basis provisions, the basis of property subject to the amended generation-skipping transfer tax generally is increased by the amount of that tax attributable to the excess of the property's value over the transferor's basis. In the case of taxable terminations occurring as a result of death, a step-up in basis like that provided under the estate tax (sec. 1014) is provided.

Property transferred in a direct skip occurring as a result of death has the same value for purposes of the generation-skipping transfer tax as the property has for estate tax purposes. Thus, if the transferor's estate elects the alternate valuation date or the current use valuation provision, the value under those provisions is used in determining the generation-skipping transfer tax. In addition, even if an estate does not elect the alternate valuation date, an election may be made to value any property transferred in a taxable distribution or a taxable termination on the alternate valuation date if the distribution or termination occurs as a result of death and the requirements of that provision are satisfied.

The special rules under which estate tax attributable to interests in certain closely held businesses may be paid in installments also apply to direct skips occurring as a result of death.

The provision permitting tax-free redemptions of stock to pay estate tax is amended to permit those redemptions to pay generation-skipping transfer tax in the case of such transfers occurring as a result of death.

Effective Dates

The amended generation-skipping transfer tax applies to transfers after the date of enactment (October 22, 1986), subject to the following exceptions:

(1) Inter vivos transfers occurring after September 25, 1985, are subject to the amended tax;

(2) Transfers from trusts that were irrevocable before September 26, 1985, are exempt to the extent that the transfers are not attributable to additions to the trust corpus occurring after that date;[12]

(3) Transfers pursuant to wills [13] in existence before the date of enactment of the Act (October 22, 1986) are not subject to tax if the decedent died before January 1, 1987; and

(4) Transfers under a trust to the extent that such trust consists of property included in the gross estate of the decedent or which are direct skips which occur by reason of the death of any decedent

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[12] The new generation-skipping transfer tax does not apply to the exercise of a limited power of appointment under an otherwise grandfathered trust or to trusts to which the trust property is appointed provided such exercise cannot postpone vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the trust. *See*, 132 *Cong. Rec.* H8362 (September 25, 1986) (colloquy between Mr. Rostenkowski and Mr. Andrews) and 132 *Cong. Rec.* S13952 (September 26, 1986) (colloquy between Senator Packwood and Senator Bentsen).

[13] Congress intended that the generation-skipping transfer tax not apply to transfers made pursuant to revocable trusts created before the date of enactment (October 22, 1986) if the grantor of the trust died before January 1, 1987. A technical amendment may be necessary for the statute to reflect this intent. Such an amendment was included in the H. Cong. Res. 395, as passed by the House of Representatives and Senate in the 99th Congress.

if the decedent was incompetent on the date of enactment of this Act (October 22, 1986) and at all times thereafter until death.

The Act provides that an election may be made to treat *inter vivos* and testamentary contingent transfers in trust for the benefit of a grandchild as direct skips if (1) the transfers occur before date of enactment of the Act (October 22, 1986), and (2) the transfers would be direct skips except for the fact that the trust instrument provides that, if the grandchild dies before vesting of the interest transferred, the interest is transferred to the grandchild's heirs (rather than the grandchild's estate). Transfers treated as direct skips as a result of this election are subject to Federal gift and estate tax on the grandchild's death in the same manner as if the contingent gift over had been to the grandchild's estate.

The existing generation-skipping transfer tax is repealed, retroactive to June 11, 1976.

The Congress adopted these delays in effective dates to permit a reasonable period for individuals to re-execute their wills to conform to the extension of generation-skipping transfer tax to direct skips. No comparable period was provided for generation-sharing transfers because those transfers were subject to generation-skipping transfer tax under present law.

Revenue Effect

These provisions are estimated to decrease fiscal year budget receipts by $3 million in 1987, $7 million in 1988, $7 million in 1989, $8 million in 1990, and $8 million in 1991.

TITLE XV—COMPLIANCE AND TAX ADMINISTRATION

A. Penalties

1. Penalties for failure to file information returns or statements (sec. 1501 of the Act and secs. 6652, 6676, and 6678, and new secs. 6721, 6722, 6723, and 6724 of the Code)[1]

Prior Law

Under prior and present law, the Code requires that information returns be filed with the IRS, and a copy be given to the taxpayer, detailing all wages, most other types of income, and some deductions. These requirements apply to a variety of specific payments, and are described in a number of Code provisions.

The Code also provides civil penalties for failure either to file an information return with the IRS (sec. 6652) or to provide a copy to the taxpayer (sec. 6678). The general penalty for failure to supply an information return to the IRS is separate from the penalty for failure to give a copy to the taxpayer. Generally, these penalties are $50 for each failure; under prior law, the maximum penalty under each provision was $50,000 per calendar year.

The Code also provides a penalty of either $5 or $50 (depending on the nature of the failure) for failure to furnish a correct taxpayer identification number (for individuals, the social security number) (sec. 6676). Under prior law, the Code did not provide a penalty for including other incorrect information on an information return.

Reasons for Change

Congress believed that simplifying these penalties, consolidating them, and making them more comprehensible would have a beneficial impact on tax compliance. Taxpayers will be able to understand more easily the consequences of noncompliance, and the administration of these penalties by the IRS should be facilitated by this simplification and consolidation.

Congress also believed that persons required to file these information returns (and provide copies to payees) who include incorrect information on them should be subject to a penalty.

Congress was concerned that the current maximum of $50,000 per calendar year for each of these penalties might diminish the efficacy of these penalties in instances where there has been a massive failure to file these information returns. Congress was also concerned, however, that total elimination of these maximum amounts could subject taxpayers to enormous potential liability that would be disproportionate both to the taxpayer's culpability and to the penalties for many other Federal offenses. Consequently, Congress preserved a maximum amount for each of these penalties, but also raised the dollar amounts of those maximums.

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[1] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1301; H.Rep. 99-426, pp. 829-831; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 501; S.Rep. 99-313, pp. 175-177; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 777-778 (Conference Report).

Explanation of Provision

The Act consolidates the penalty for failure to file an information return with the IRS with the penalty for failure to supply a copy of that information return to the payee in the same subchapter of the Code. The general level of each of these penalties remains at $50 for each failure. The maximum penalty is raised from $50,000 to $100,000 per calendar year for each category of failure.[2] Thus, a maximum penalty of $100,000 applies to failures to file information returns with the IRS, and another maximum penalty of $100,000 applies to failures to supply copies of information returns to payees.

As under prior law, the Act imposes these penalties without limits where the failure to file information returns with the IRS is due to intentional disregard of the filing requirement. The Act also provides, as did prior law, generally higher penalties for each failure to file where the failure to file is due to intentional disregard. The Act modifies the levels of these higher penalties for certain specified failures. Thus, the penalty for failure to report cash transactions that exceed $10,000[3] is increased to 10 percent of the amount that should have been reported. Also, the penalty for failure to report exchanges of certain partnership interests[4] or failure to report certain dispositions of donated property[5] is 5 percent of the amount that should have been reported.

These provisions have generally been redrafted to improve their comprehensibility and administrability. In light of this redrafting, the Act repeals the prior-law penalty for failure to furnish an information return to the IRS (sec. 6652(a)) and the prior-law penalty for failure to supply a copy of the information return to the payee (sec. 6678).

The Act also adds to the Code a new penalty for failure to include correct information either on an information return filed with the IRS or on the copy of that information return supplied to the payee. This new penalty applies to both an omission of information or an inclusion of incorrect information. The amount of the penalty is $5 for each information return or copy for the payee, up to a maximum of $20,000 in any calendar year. This maximum does not apply in cases of intentional disregard of the requirement to file accurate information returns.

This new penalty does not apply to an information return if a penalty for failure to supply a correct taxpayer identification number has been imposed with respect to that information return. Thus, if the person filing an information return is subject to a penalty under section 6676 for including an incorrect social security number on the information return, this new penalty is not imposed with respect to that information return.

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[2] The Act also raises from $50,000 to $100,000 per calendar year the maximum penalty for failure to supply taxpayer identification numbers (sec. 6676).

[3] *See* Code sec. 6050I.

[4] *See* Code sec. 6050K.

[5] *See* Code sec. 6050L.

This new penalty is intended to provide to persons filing information returns an incentive both to file accurate and complete information returns initially and to correct as rapidly as possible any incorrect information returns that may have been filed. If a person files what purports to be an information return, but which contains so many inaccuracies or omissions that the utility of the document is minimized or eliminated, the IRS may under circumstances such as these (as it did under prior law) impose the penalty for failure to file an information return, rather than this new penalty for filing an information return that includes inaccurate or incomplete information. If the IRS imposes a penalty for failure to file an information return, it may not in addition impose a penalty for filing an incorrect information return with respect to the same information.

As under prior law, there is an exception from all of these penalties if the failure to file an information return with the IRS, to provide a copy to the payee, or to include correct information on either of those returns is due to reasonable cause and not to willful neglect. Thus, under this standard, if a person required to file fails to do so because of negligence or without reasonable cause, that person would be subject to these penalties. The Act retains the higher standards and special rules of prior law that apply to failures with respect to interest or dividend returns or statements.

The Act also clarifies a number of the substantive information reporting provisions of the Code relating to furnishing a written statement to the payee. Under prior law, a number of these provisions arguably might have been technically effective only if the person required to supply the copy to the payee had actually filed the information return with the IRS. These provisions were redrafted so that it is clear that the requirement to supply a copy of the information return to the payee is triggered when there is an obligation to file (instead of the actual filing of) an information return with the IRS.

Effective Date

The provision is effective for information returns the due date of which (determined without regard to extensions) is after December 31, 1986, except that certain modifications of the information return provisions for interest, dividends, and patronage dividends are effective on the date of enactment (*see* Modification of separate mailing requirement for certain information reports, C.6., below).

2. Increase in penalty for failure to pay tax (sec. 1502 of the Act and sec. 6651 of the Code)[6]

Prior Law

Under prior and present law, the Code provides that a taxpayer who fails to pay taxes when due must pay a penalty (sec. 6651(a)(2)

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[6] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1302; H.Rep. 99-426, pp. 831-833; H.R. 3838,

Continued

and (3)). The penalty applies to a taxpayer who fails to pay taxes shown on the tax return. It also applies to a taxpayer who fails to pay taxes not shown on the tax return within 10 days of notice and demand for payment by the IRS. Under prior law, the penalty was one-half of one percent of the tax for the first month not paid, and is an additional one-half of one percent for each additional month the failure to pay continues, up to a maximum of 25 percent.

This penalty can be abated if the failure is due to reasonable cause and not willful neglect. This penalty is not deductible for tax purposes.

Reasons for Change

Congress agreed with the President's tax reform proposal that it is appropriate that taxpayers who delay payment of properly owed taxes should pay penalties approximately equal to the overall cost of collecting these delinquent taxes. Thus, the cost of collecting these delinquent taxes would in effect be borne by those who have delayed making payment, rather than by all taxpayers.

Congress believed that it is important that the penalty operate in a reasonably simple and generally uniform manner. Consequently, Congress did not adopt a cost of collection charge system, under which a taxpayer would be required to pay for the specific costs of the specific IRS actions required to collect the delinquent taxes from that taxpayer. Instead, Congress maintained the general structure of the prior-law penalty for failure to pay taxes, but increased the amount of the penalty once the IRS generally initiates more expensive collection methods.

Explanation of Provision

The Act modifies the penalty for failure to pay taxes by increasing in specified situations the amount of that penalty from one-half of one percent per month to one percent per month.[7] This increase occurs after the IRS notifies the taxpayer that the IRS will levy upon the assets of the taxpayer. The IRS can do this in either of two ways. The most common method is that the IRS sends to the taxpayer a notice of intention to levy; this notice must be sent out at least 10 days before the levy occurs (sec. 6331(d)). In these circumstances, the increase in the penalty occurs at the start of the month following the month in which the 10-day period expires. The second method may be used when the IRS finds that the collection of the tax is in jeopardy. If this occurs, the IRS may make notice and demand for immediate payment of the tax, and, if the tax is not paid, the IRS may levy upon the assets of the taxpayer without regard to the 10-day requirement (sec. 6331(a)). Under this second method, the IRS makes notice and demand for immediate payment either in person or by mail. In these circumstances, the increase in the penalty occurs at the start of the month following the month in which notice and demand is made.

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as reported by the Senate Committee on Finance on May 29, 1986, sec. 502; S.Rep. 99-313, pp. 177-179; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 778-779 (Conference Report).

[7] Once the penalty rate in effect is one percent for any month with respect to a particular taxable year and type of tax, the one-percent rate is applicable to any penalty for failure to pay taxes for that taxpayer for all subsequent months.

This increase in the rate of this penalty generally will occur after the IRS has made repeated efforts to contact the taxpayer by mail.[8] During the period that these initial mailings are made, the penalty for failure to pay taxes remains at one-half of one percent. When the cycle of mailings is completed and the tax has not yet been paid, the IRS must switch to methods of collecting the tax that generally are much more expensive, such as telephoning or visiting the taxpayer. This is the point at which generally the penalty increases to one percent per month.

The Act also improves the coordination of the penalty for failure to pay taxes with the penalty for failure to file a tax return. Under prior law, a taxpayer who did not file his tax return on time may have been liable for a smaller total penalty (consisting of both the failure to file penalty and the failure to pay penalty) if the taxpayer never filed a return than if the taxpayer filed the return late. This occurred because the special rules of section 6651(c)(1)(B) in effect reduced the failure to pay penalty by the failure to file penalty. Congress viewed this result as anomalous and, accordingly, repealed this special offset rule.

Effective Date

The increase in the penalty for failure to pay taxes (as well as the repeal of the special coordination rule of section 6651(c)(1)(B)) is effective for periods after December 31, 1986.

3. Negligence and fraud penalties (sec. 1503 of the Act and sec. 6653 of the Code)[9]

Prior Law

Negligence

Under prior and present law, taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations (but without intent to defraud) (Code sec. 6653(a)). There are two components to this penalty. The first component is 5 percent of the total underpayment, where any portion of the underpayment is attributable to negligence or intentional disregard of rules or regulations. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to negligence is $200, the amount of the penalty is $50 (5 percent of $1,000). The second component is an amount equal to one-half the interest payable on the portion of the underpayment attributable to negligence or intentional disregard, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier).

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[8] Generally, the IRS sends taxpayers a series of four or five letters demanding payment before a levy is made. These letters will go out over a period of approximately six months. The IRS will, however, truncate the number of letters and the time between them for reasons such as concern that delay will jeopardize collection.

[9] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1303; H.Rep. 99-426, pp. 833-836; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 503; S.Rep. 99-313, pp. 179-182; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 779-782 (Conference Report).

Generally, once the IRS has determined that negligence existed, the burden is on the taxpayer to establish that the IRS' determination of negligence is erroneous. The taxpayer must meet a higher standard in the case of interest or dividend payments (sec. 6653(g)). This section provides that if the taxpayer fails to include in income an interest or dividend payment shown on an information return, the portion of the underpayment attributable to this failure is treated as due to negligence in the absence of clear and convincing evidence to the contrary. The effect of this provision is that the IRS may automatically assert the negligence penalty in these circumstances, and the taxpayer must present clear and convincing evidence that no negligence was involved in order to avoid the penalty.

Under prior law, the negligence penalty applied only to underpayments of income taxes, gift taxes, and the windfall profits tax.

Fraud

Under prior and present law, taxpayers are also subject to a penalty if any part of an underpayment of tax is due to fraud (sec. 6653(b)). This penalty is in lieu of the negligence penalty. There are two components to the fraud penalty. Under prior law, the first component was 50 percent of the total underpayment, where any portion of the underpayment is attributable to fraud. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to fraud is $500, this component of the penalty is $500 (50 percent of $1,000). Under prior and present law, the second component is an amount equal to one-half the interest payable on the portion of the underpayment attributable to fraud, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier). Under prior and present law, the burden of proof is on the IRS to establish that fraud existed (sec. 7454(a)) with respect to an item on the taxpayer's return.

Reasons for Change

Congress was concerned that the negligence and fraud penalties have not been applied in a large number of cases where their application is fully justified. Congress consequently modified several aspects of these penalties in order to improve their operation. In addition, however, Congress emphasized that the IRS and the courts share significant responsibility to ensure that these penalties are fully asserted in appropriate instances.

In particular, Congress believed that the negligence penalty should apply to all taxes under the Code. Congress also believed that while the current special negligence penalty applicable to failure to include as income interest or dividends shown on an information return is appropriate, its scope was too narrow. Congress believed that, if a taxpayer is provided an information return with respect to an item that should appear on the taxpayer's tax return, but the taxpayer neglects to report that item, that taxpayer should be subject to a penalty. Consequently, Congress expanded the scope of this special negligence penalty so that it applies (absent clear and convincing evidence to the contrary) to any item reported on an information return that is not properly reported on the taxpayer's tax return.

Congress was also concerned that the current applicability of the fraud penalty to the entire underpayment of tax (once the IRS has established fraud with respect to any portion of the underpayment) may decrease the efficacy of this penalty. Congress was concerned that imposing the same penalty on two taxpayers who have identical underpayments, one attributable wholly to fraud and the other attributable only in part to fraud, may be an insufficient deterrent to fraudulent behavior. Consequently, Congress narrowed the scope of the fraud penalty so that it applies only to the portion of the underpayment attributable to fraud. Congress concomitantly increased the level of this penalty. Congress believed that these modifications more appropriately target the fraud penalty to fraudulent behavior.

Explanation of Provision

Negligence

The Act expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The Act also generally redrafts the negligence penalty to make it clearer and more comprehensible. One element of that redrafting involves the provision of a definition of negligence. The Act includes within the definition of negligence both any failure to make a reasonable attempt to comply with the provisions of the Code as well as any careless, reckless, or intentional disregard of rules or regulations. The Act does not, however, limit the definition of negligence to these items only. Thus, all behavior that was considered negligent under prior law remains within the scope of this negligence penalty. Also, any behavior that is considered negligent by the courts but that is not specifically included within this definition is also subject to this penalty.

The Act also expands the scope of the special negligence penalty that is currently applicable to failures to include in income interest and dividends shown on an information return. The Act expands this provision so that it is applicable to failures to show properly on the taxpayer's tax return any amount that is shown on any information return. This penalty applies to the same information returns that are subject to the penalties for failure to provide information returns, described above (new sec. 6724(d)(1)). Thus, if a taxpayer fails to show properly on the taxpayer's tax return any amount that is shown on an information return, the taxpayer's failure is treated as negligent in the absence of clear and convincing evidence to the contrary.

The Act does not increase the rate of the negligence penalty or apply it only to the portion of the underpayment attributable to negligence. Instead, the Act maintains the 5-percent rate of prior law, and the prior-law application of that penalty to the entire amount of the underpayment, not just to the portion of the underpayment attributable to negligence.[10]

Fraud

The Act modifies the fraud penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the Act increases the rate of the basic fraud penalty from 50 to 75 percent. (The time-sensitive component of the fraud penalty is not altered.) Second, the scope of the fraud penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to fraud (this is the same amount to which the prior- and present-law time-sensitive component of the fraud penalty applies). The Act does this by providing that, once the IRS has established that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. This is done so that, once the IRS has initially established that fraud occurred, the taxpayer then bears the burden of proof to establish the portion of the underpayment that is not attributable to fraud. Congress believed that this rule is appropriate in that these facts are generally within the taxpayer's control. It was nonetheless the intention of Congress that the fraud penalty apply only to the portion of the underpayment attributable to fraud. The fraud penalty is determined at the top marginal rate applicable to the taxpayer.[11]

These modifications to the fraud penalty do not affect the statute of limitations for false or fraudulent returns (sec. 6501(c)). Thus, if a taxpayer files a return that is in some respects fraudulent, the statute of limitations with respect to the entire return never expires.

Interaction of negligence and fraud penalties

If an underpayment of tax is partially attributable to negligence and partially attributable to fraud, the negligence penalty (which generally applies to the entire underpayment of tax) does not apply to any portion of the underpayment with respect to which a fraud penalty is imposed.

Effective Date

The amendments to the negligence and fraud penalties are applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1986.

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[10] In a recent case, the Sixth Circuit held that the negligence penalty "should be applied only to that portion of the deficiency attributable to [the negligent action]." (*Asphalt Products Co.* v. *Comm'r.*, Nos. 84-1841, 84-1882, slip op. (6th Cir. July 17, 1986)). The Act provides that the negligence penalty applies (once one element of negligence has been demonstrated) to the entire underpayment, not just to the portion attributable to negligence. The Act is, with respect to this issue, a continuation of the rule of prior law, which also provided that the negligence penalty applies to the entire underpayment, not just to the portion attributable to negligence. Congress noted that this case both inaccurately states prior law and is in any event of no effect under the Act.

[11] The IRS may issue regulations implementing this rule.

4. Penalty for substantial understatement of tax liability (sec. 1504 of the Act and sec. 6661 of the Code)[12]

Prior Law

Under present and prior law, a taxpayer who substantially understates income tax for any taxable year must pay an addition to tax. Under prior law, that addition to tax was equal to 10 percent of the underpayment of tax attributable to the understatement (sec. 6661). An understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the tax return or $5,000 ($10,000 in the case of most corporations). An understatement is generally the excess of the amount of tax required to be shown on a tax return over the amount of tax actually shown on the tax return. The penalty generally does not apply to amounts with respect to which (1) there was substantial authority for the taxpayer's treatment of the amount, or (2) the taxpayer discloses the relevant facts with respect to that amount on the tax return.

Reasons for Change

This penalty was originally enacted to deter taxpayers from participating in the "audit lottery," where taxpayers take questionable positions on their tax returns in the hope that they will not be audited. These taxpayers may be able to escape the negligence and fraud penalties, because they generally have relied upon the advice of a tax advisor. Reasonable and justifiable reliance on a tax advisor generally prevents the imposition of either the negligence or fraud penalty. Congress believed that the current level of the substantial understatement penalty provides an insufficient deterrent to this type of behavior; consequently, Congress increased the level of this penalty.

Explanation of Provision

The Act increases the addition to tax for a substantial understatement of tax liability from 10 to 20 percent of the amount of the underpayment of tax[13] attributable to the understatement.[14]

Effective Date

The increase in this addition to tax is applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1986.

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[12] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 504; S.Rep. 99-313, pp. 182-183; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 782-783 (Conference Report).

[13] Examples of the types of taxes to which this provision applies include individual income taxes, corporate income taxes, and the unrelated business income tax.

[14] Sec. 8002 of the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509) increased this penalty to 25 percent of the underpayment, effective for penalties assessed after the date of enactment of the Omnibus Budget Reconciliation Act (October 21, 1986). The date of enactment of the Tax Reform Act of 1986 was October 22, 1986. Congress intended that the increase in this penalty provided by the Omnibus Budget Reconciliation Act supercede the increase provided by the Tax Reform Act, regardless of which was enacted first. A technical correction may be needed so that the statute reflects this intent.

Revenue Effect of Penalty Provisions

These penalty provisions are estimated to increase fiscal year budget receipts by $356 million for 1987, $444 million for 1988, $484 million for 1989, $487 million for 1990, and $491 million for 1991.

B. Interest Provisions

1. Differential interest rate (sec. 1511 of the Act and sec. 6621 of the Code)[15]

Prior Law

Under prior and present law, taxpayers must pay interest to the Treasury on underpayments of tax (Code sec. 6601). Interest generally accrues from the due date of the tax return (determined without regard to extensions). The Treasury must pay interest to taxpayers on overpayments of tax (sec. 6611).

Under prior law, both the rate taxpayers paid to the Treasury and the rate the Treasury paid to taxpayers were the same rate (sec. 6621). That rate was determined semi-annually for the 6-month periods ending on September 30 and March 31. The adjusted rate took effect on the following January 1 (for September 30 determinations) and July 1 (for March 31 determinations). The rate utilized was the prime rate quoted by large commercial banks as determined by the Board of Governors of the Federal Reserve System.

Reasons for Change

Congress was concerned that these interest provisions were not modeled sufficiently closely on other interest rates in the economy; this may have produced distortive effects. First, Congress was concerned that both the interest rate taxpayers paid the Treasury and the rate the Treasury paid to taxpayers were the same rate. Few financial institutions, commercial operations, or other entities, borrow and lend money at the same rate. Thus, either the rate taxpayers paid the Treasury or the rate the Treasury paid taxpayers was necessarily out of line with general interest rates in the economy. This distortion may have caused taxpayers either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate. Consequently, Congress approved a one-percent differential between these two interest rates.

Second, Congress was concerned that the prime rate, which was the basis for interest determinations under prior law, was not as reflective of actual market rates involving transactions with the Government as other rates were. Consequently, Congress based the interest rate on the Federal short-term rate.

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[15] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1331; H.Rep. 99-426, pp. 849-850; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 511; S.Rep. 99-313, pp. 184-185; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 784-785 (Conference Report).

Explanation of Provision

The Act provides that the interest rate that Treasury pays to taxpayers on overpayments is the Federal short-term rate plus 2 percentage points. The Act also provides that the interest rate that taxpayers pay to the Treasury on underpayments is the Federal short-term rate plus 3 percentage points. The rates are rounded to the nearest full percentage.

The interest rates are to be adjusted quarterly. The rates are determined during the first month of a calendar quarter, and become effective for the following calendar quarter. Thus, for example, the rates that are determined during January are effective for the following April through June. This reduces by one month (from three months to two) the lag that existed in prior law between the determination of the interest rate and the date it became effective.

The interest rates are determined by the Secretary based on the average market yield on outstanding marketable obligations of the United States with remaining periods to maturity of three years or less. This is the mechanism for determining short-term Federal rates, which are used to test the adequacy of interest in certain debt instruments issued for property and certain other obligations (*see* sec. 1274(d)).

Section 6601(f) provides that, to the extent a portion of tax due is satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax. Consequently, if an underpayment of $1,000 occurs in year 1 and an overpayment of $1,000 occurs in year 2, no interest is imposed in year 2 because of the rule of section 6601(f). The IRS can at present net many of these offsetting overpayments and underpayments. Nevertheless, the IRS will require a transition period during which to coordinate differential interest rates with the requirements of section 6601(f). The Act, therefore, provides that the Secretary of the Treasury may prescribe regulations providing for netting of tax underpayments and overpayments through the period ending three years after the date of enactment of the Act. By that date, the IRS should have implemented the most comprehensive netting procedures that are consistent with sound administrative practice.

Effective Date

This provision is effective for purposes of determining interest for periods after December 31, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $270 million for 1987, $406 million for 1988, $319 million for 1989, $461 million for 1990, and $612 million for 1991.

2. Interest on accumulated earnings tax (sec. 1512 of the Act and sec. 6601 of the Code)[16]

Prior Law

Under prior and present law, the accumulated earnings tax (sec. 531) is imposed to prevent corporations from accumulating (rather than distributing) income with the intent of reducing or avoiding taxes. Under prior law, interest was charged only from the date the IRS demanded payment of the tax, rather than the date the return was originally due to be filed.[17]

Reasons for Change

Congress believed that it is appropriate to impose interest on underpayments of the accumulated earnings tax in the same manner that interest is imposed for most other taxes in the Code. Consequently, interest is imposed under the Act from the date the return was originally due to be filed.

Explanation of Provision

The Act provides that interest is imposed on underpayments of the accumulated earnings tax from the due date (without regard to extensions) of the income tax return for the year the tax is initially imposed.

Effective Date

This provision is effective for returns that are due (without regard to extensions) after December 31, 1985.

Revenue Effect

This provision is estimated to have a negligible effect on fiscal year budget receipts.

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[16] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1332; H.Rep. 99-426, pp. 850-851; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 512; S.Rep. 99-313, pp. 185-186; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 785 (Conference Report).

[17] *See* Rev. Rul. 72-324, 1972-1 C.B. 399.

C. Information Reporting Provisions

1. Information reporting on real estate transactions (sec. 1521 of the Act and sec. 6045 of the Code)[18]

Prior Law

Under prior and present law, brokers must, when required by Treasury regulations, file information returns on the business they transact for customers (sec. 6045). Prior to the date of enactment, the IRS had issued regulations requiring reporting only of gross proceeds of sales of securities, commodities, regulated futures contracts, and precious metals. Reporting on real estate transactions was not required under these regulations. The term "broker" is broadly defined as any person who, in the ordinary course of a trade or business, stands ready to effect sales to be made by others (Treas. Reg. sec. 1.6045-1).

Reasons for Change

Congress was concerned that a sizeable number of real estate transactions that should be reported on tax returns were not being reported. Consequently, Congress determined that it is appropriate to expand the current system of information reporting to include reporting on real estate transactions.

Explanation of Provision

The Act requires that real estate transactions be reported. The Act provides that the primary responsibility for reporting is on the person responsible for closing the transaction, including any title company or attorney who closes the transaction. This is generally the person conducting the settlement. Treasury may issue regulations specifying who is the person responsible for closing the transaction, because it may not be clear which of several persons is the one responsible for closing the transaction. (These regulations need not rely upon the presence or absence of a legal obligation at closing.) Thus, Treasury may provide uniform rules to determine which of the persons involved with the closing is the one with primary responsibility for the information reporting.

If there is no person responsible for closing the transaction, the reporting must be done by the mortgage lender. If there is no mortgage lender, the reporting must be done by the seller's broker. If there is no seller's broker, the reporting must be done by the buyer's broker. If there is no buyer's broker, the reporting is to be done in accordance with regulations to be prescribed by the Secretary.

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[18] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1341; H.Rep. 99-426, p. 855; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 521; S.Rep. 99-313, pp. 187-188; Senate floor amendment, 132 Cong. Rec. S7968-7969 (June 19, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 786-787 (Conference Report).

The Secretary is to provide guidance to taxpayers on how this information reporting is to be accomplished well before the effective date of this provision. The Secretary should provide guidance as to what real estate transactions are subject to information reporting. Transfers of stock in cooperative housing corporations are considered to be real estate transactions subject to this reporting requirement. Similarly, acquisitions of real property for use as rights-of-way are considered to be real estate transactions subject to this reporting requirement. The Secretary may also exclude from information reporting certain types of real estate transactions where information reporting on those transactions would not be useful. Congress anticipated that information reporting would not be required on gifts, refinancings of real estate or other transactions that do not give rise to income tax liability, unless the Secretary otherwise provides. Similarly, it is contemplated that information reporting will not be required on sales of burial vaults or plots in cemeteries or on other transactions similar to this, where the burden of compliance substantially outweighs the benefits from the reporting, unless the Secretary otherwise provides. The Secretary should also provide guidance as to the gross proceeds required to be reported.

Congress anticipated that this information reporting would be done on a Form 1099, similar to that required for other transactions effected by brokers. Congress also anticipated that the rules requiring that information returns from brokers be filed on magnetic media (*see* sec. 6011(e)) will encompass these information returns on real estate. Thus, all the information returns required to be filed by one entity would generally be filed together in one magnetic media filing. Because the provision is drafted so that mandatory reporting on real estate transactions is done under the general information reporting requirements relating to brokers (sec. 6045(a) and (b)), all penalties and related provisions that apply to the general broker reporting requirements also apply to reporting on real estate transactions.

The Act provides that real estate transactions will be subject to backup withholding (sec. 3406) only to the extent required by Treasury regulations. Congress expected Treasury to provide taxpayers with guidance as to how backup withholding is to be implemented with respect to real estate transactions.

Effective Date

The provision is effective for real estate transactions with respect to which closing on the contract occurs on or after January 1, 1987. Real estate transactions on or after that date must be reported without regard as to whether the Treasury has issued regulations under section 6045(a) requiring that a return be filed. Thus, this provision (unlike the general broker reporting requirements of sec. 6045) is effective in the absence of implementing regulations. Congress expected that the IRS will provide taxpayers with timely guidance as to how to comply with the requirements of this provision.

2. Information reporting on persons receiving contracts from certain Federal agencies (sec. 1522 of the Act and new sec. 6050M of the Code)[19]

Prior Law

There was no provision of prior law that required information reporting on persons receiving Federal contracts.

Reasons for Change

Congress was concerned that the dollar amount of taxes owed to the Federal Government that the IRS has attempted repeatedly to collect but cannot collect has grown in recent years to over $9.1 billion. Congress was also concerned that those who reap the benefits of Federal contracts also fulfill their Federal obligation of paying their taxes. Therefore, Congress determined that it is appropriate to require information reporting from a Federal agency that enters into a contract. These information returns will notify the IRS of a source from which delinquent taxes may be collected, which will facilitate the collection of these delinquent taxes.

Explanation of Provision

The Act requires the head of each Federal executive agency to file an information return indicating the name, address, and taxpayer identification number (TIN) of each person with which the agency enters into a contract. The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the returns useful as a source of information for collection purposes. Thus, it would be appropriate to require that these information returns be filed within a certain time period (such as 30 days) of signing the contract, rather than at the end of the calendar year. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts.

In some instances, several corporations, each with its own TIN, file one consolidated return. The Secretary has the authority to require that the information returns include the corporation's own TIN, as well as the TIN under which it files the consolidated return, so that the matching of Federal contracts with delinquent tax liability can be facilitated.

This provision does not enlarge the collection procedures now available to the Service. Rather, these new information returns will inform the IRS of a possible source of collection in the event taxes are unpaid.

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[19] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1342; H.Rep. 99-426, p. 856; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 522; S.Rep. 99-313, pp. 188-189; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 787-788 (Conference Report).

Effective Date

This provision is effective on January 1, 1987. Thus, all contracts signed on or after that date are subject to information reporting. In addition, all contracts signed prior to that date are subject to information reporting if they are still in effect on that date.

3. Information reporting on royalties (sec. 1523 of the Act and new sec. 6050N of the Code)[20]

Prior Law

Under prior and present law, a number of provisions of the Code require that payors of specified payments report those payments to the IRS and provide a copy of the information report to the taxpayer receiving the payment. Section 6041 is the broadest of these provisions; this section requires information reporting on "rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income." The Treasury regulations for this section specifically require information reporting on royalties.

Information reporting under section 6041 applies to payments totaling $600 or more during the taxable year. Other information reporting provisions, such as those for interest (sec. 6049), dividends (sec. 6042), patronage dividends (sec. 6044), and unemployment compensation (sec. 6050B), apply to payments totaling $10 or more during the taxable year.

Reasons for Change

Congress was concerned that the voluntary reporting level for royalties is appreciably lower than it is for many other types of income. One reason for this is that some payors currently required to report on royalties are not doing so. This may occur because of the lack of specificity in the present-law requirements. Another reason that voluntary reporting on royalties may be inadequate is that the dollar level at which payments are reported under present law is higher than it is for many other types of payments, such as interest or dividends. Consequently, Congress both made the information reporting requirements with respect to royalties more specific and lowered the threshold level at which this information reporting begins to conform it to interest and dividend reporting.

Explanation of Provision

The Act includes a new provision of the Code that requires persons who make payments of royalties aggregating $10 or more to any other person in a calendar year to provide an information report on the royalty payments to the IRS. These persons must also provide a copy of this information report to the payee. If a person makes payments to a nominee, the nominee must report the information to the ultimate payee and to the IRS, as required in Treasury forms or regulations. Examples of royalty payments required to be reported under this provision include royalty payments with respect to the right to exploit natural resources, such as oil, gas, coal, timber, sand, gravel, and other mineral interests, as well as royalty payments for the right to exploit intangible property, such as copyrights, trade names, trademarks, franchises, books and other literary compositions, musical compositions, artistic works, secret processes or formulas, and patents.

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[20] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 523; S.Rep. 99-313, pp. 189-190; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 788-789 (Conference Report).

The generally applicable rules for information returns for payments of interest and dividends apply to this provision. Thus, the information report to the payee must be provided by the end of January and the report to the IRS must be provided by the end of February of the year following the year in which the payments were made. Payors filing large numbers of these reports with the IRS are subject to the general magnetic media filing requirements of section 6011(e)(1). If the payee does not furnish the payor with the payee's taxpayer identification number (for individuals, the social security number), the royalty payments generally are subject to backup withholding.

Effective Date

This provision is effective for royalty payments made after December 31, 1986.

4. Taxpayer identification numbers (TINs) required for dependents claimed on tax returns (sec. 1524 of the Act and secs. 6109 and 6676 of the Code)[21]

Prior Law

Under prior and present law, the taxpayer (and the taxpayer's spouse, if they file a joint return) must put his taxpayer identification number (TIN) on his tax return. There was no requirement under prior law that a taxpayer claiming a dependent on a tax return report the TIN of that dependent on that tax return.

A taxpayer's TIN is generally that taxpayer's social security number. Some taxpayers are exempted from social security self-employment taxes due to their religious beliefs. These taxpayers do not have a social security number; instead, the IRS administratively assigns them a taxpayer identification number.

Reasons for Change

Congress believed that it is important to ensure the validity of claims for dependents on tax returns. Some taxpayers claim dependents that the taxpayers are not entitled to claim. For example, following a divorce, both parents may continue to claim the children as dependents, even though only one of the parents is legally entitled to claim the children as dependents.

Congress chose to increase compliance in this area by requiring that a taxpayer include on the taxpayer's tax return the taxpayer identification number (TIN) of any dependent claimed on that tax return who is at least 5 years old. A taxpayer's TIN is almost always that taxpayer's social security number. Because nearly everyone ultimately must obtain a social security number, it was considered appropriate, in light of the noncompliance in this area, to require that these numbers be included on tax returns. Congress also provided special rules for taxpayers whose religious beliefs affect their participation in social security.

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[21] For legislative background of the provision, *see*: Senate floor amendment, 132 Cong. Rec. S7893-7898 (June 19, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 789-790 (Conference Report).

Explanation of Provision

A taxpayer claiming a dependent who is at least 5 years old must report the taxpayer identification number of that dependent on that tax return. The penalty for failing to include the TIN of a dependent (or for including an incorrect TIN) is $5 per TIN per return. In addition, once the IRS has asked the taxpayer to supply the missing TIN but the taxpayer fails to do so, the IRS may continue its current practice of denying any deduction for a dependent if it cannot be established that it is proper to claim that dependent on the tax return.

Congress noted that certain taxpayers, because of their religious beliefs, are exempted from the social security self-employment taxes (sec. 1402(g)). Congress intended that these taxpayers and their dependents who currently acquire their TINs from the IRS continue to be permitted to do so. It was the intent of Congress that these taxpayers continue to be exempted from the general requirement of obtaining a social security number from the Social Security Administration. Others of these taxpayers obtain their TINs under special procedures with the Social Security Administration. Congress intended that these procedures continue to be available to these taxpayers.

Effective Date

This provision is effective for returns due on or after January 1, 1988 (without regard to extensions). Congress delayed this effective date for one year so that taxpayers may apply for and receive TINs for their dependents who do not have them well in advance of the due date of the returns on which the TINs must be provided. In addition, this delay will provide sufficient time for the IRS and the Social Security Administration to publicize this new requirement extensively.

5. Tax-exempt interest required to be shown on tax returns (sec. 1525 of the Act and sec. 6012 of the Code)[22]

Prior Law

There was no requirement under prior law that all taxpayers report the amount of tax-exempt interest they receive on their tax returns. The individual income tax return (Form 1040) for 1985 does, however, require that taxpayers with taxable social security benefits report the tax-exempt interest they receive.

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[22] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1343; H.Rep. 99-426, pp. 857-858; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 790 (Conference Report).

Reasons for Change

Congress believed that it is necessary, in order to calculate the correct taxable amount of social security and the correct amount of the minimum tax, to require that all taxpayers (whether individual, corporate, or other) report on their tax returns the tax-exempt interest they receive. This information will also be helpful in assuring that taxpayers comply with the provisions of section 265 (relating to the denial of a deduction for interest to purchase or carry tax-exempt obligations).

Explanation of Provision

The Act requires that any person required to make a return of income under section 6012 include on that return the amount of tax-exempt interest received or accrued during the taxable year.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

6. Modification of separate mailing requirement for certain information reports (secs. 501(c) (2), (3) and (5) and 1523 of the Act and secs. 6042, 6044, and 6049 and new sec. 6050N of the Code)[23]

Prior Law

Under prior and present law, payors of interest, dividends, and patronage dividends are required to report to the IRS the amounts of these payments that the payors make (secs. 6042, 6044, and 6049). Payors are required to provide a copy of this information report to the payee who received the payment. These information reports must be made on the official IRS form (Form 1099) or an authorized substitute. The Code requires that the copy of the information report supplied to the payee must be provided either in person or in a separate, first-class mailing. Generally, nothing other than the information report was permitted, under prior law, to be enclosed in the envelope.

Reasons for Change

Congress was concerned that the separate mailing requirement for information returns might impose significant burdens on payors. At the same time, however, Congress was concerned that there be no significant degradation in voluntary compliance with respect to the reporting of these payments on taxpayers' tax returns. Consequently, Congress made specific modifications to the separate mailing requirement that will reduce the burden on payors but at the same time will not substantially diminish voluntary reporting by taxpayers.

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[23] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, secs. 501(c)(2), (3), and (5) and 523; S.Rep. 99-313, pp. 190-191; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 791 (Conference Report).

Explanation of Provision

The Act replaces the separate mailing requirement of prior law with a statement mailing requirement and extends the statement mailing requirement to reportable royalties. Consequently, the Act provides that payors of interest, dividends, patronage dividends, and royalty payments must provide copies of information returns to the payee either in person (as was provided under prior law) or in a statement mailing by first-class mail. The only enclosures that can be made with a statement mailing are: (1) a check, (2) a letter explaining why no check is enclosed (such as, for example, because a dividend has not been declared payable), or (3) a statement of the payee's specific account with the payor (such as a year end summary of the payee's transactions with the payor).[24] The envelope must state on the outside "Important Tax Return Document Enclosed." In addition, each enclosure (i.e., the check, the letter, or the account statement) must state "Important Tax Return Document Enclosed." Thus, a mailing is not a statement mailing if it encloses any other material, such as advertising, promotional material, a bill, or a quarterly or annual report. Congress did not permit additional material such as this to be enclosed because such enclosures may make it less likely that some taxpayers will recognize the importance of the information report and utilize the information report in completing their tax returns. Congress retained the requirements of prior law that the information return be made on an official form and be provided to the payee either in person or by first-class mail. For purposes of this provision, a statement mailing includes a separate mailing satisfying the prior-law requirements.

Effective Date

This provision is effective for information returns required to be filed after December 31, 1986. IRS regulations permit several types of information returns to be mailed prior to December 31 under certain conditions. Payors satisfying those conditions are able to take advantage of this liberalized enclosure rule for those types of information returns as well, provided that they are mailed after the date of enactment.

Revenue Effect of Information Reporting Provisions

These information reporting provisions are estimated to increase fiscal year budget receipts by $75 million in 1987, $466 million in 1988, $871 million in 1989, $1,027 million in 1990, and $1,068 million in 1991.

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[24] These are in addition to the other enclosures, such as other information reports or tax forms, that the IRS currently permits to be enclosed.

D. Tax Shelters

1. Tax shelter registration (sec. 1531 of the Act and sec. 6111 of the Code)[25]

Prior Law

Under prior and present law, tax shelter organizers are required to register with the IRS tax shelters they organize, develop, or sell (sec. 6111). Under prior law, a tax shelter is any investment for which the ratio of the deductions plus 200 percent of the credits to the cash actually invested is greater than 2 to 1. The investment also must (1) be subject to Federal or State securities requirements, or (2) be privately placed with 5 or more investors with an aggregate amount that may be offered for sale exceeding $250,000.

Reasons for Change

Multiplying tax credits by 200 percent yields the equivalent value of those credits in terms of deductions at a 50-percent rate of tax. If the tax rate is lowered (as is done in this Act), the percentage against which tax credits must be multiplied must be increased in order to maintain the proper conversion of those credits into deduction-equivalents.

Explanation of Provision

Tax credits are multiplied by 350 percent (instead of 200 percent) to conform the tax shelter ratio computation more closely to the new tax rate schedule in the Act.

Effective Date

This provision is effective with respect to any tax shelter interests in which are first offered for sale after December 31, 1986.

2. Tax shelter penalties

a. Penalty for failure to register a tax shelter (sec. 1532 of the Act and sec. 6707(a) of the Code)[26]

Prior Law

Prior law and present law require specified tax shelters to register with the IRS and obtain a tax shelter identification number (*see* previous item). Under prior law, the penalty for failure to register a tax shelter with the IRS was $10,000 or, if less, one percent of the aggregate amount invested in the tax shelter (but in no event less than $500) (sec. 6707(a)).

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[25] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 532; S.Rep. 99-313, p. 193; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 793-794 (Conference Report).

[26] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 533; S.Rep. 99-313, pp. 193-194; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 794 (Conference Report).

Reasons for Change

Congress believed that registration of tax shelters is an important tool that enables the IRS to detect questionable shelters at the early stages of their development. Congress believed that the prior-law maximum penalty of $10,000 may have been an insufficient deterrent for failure to register a tax shelter. Consequently, Congress deleted the maximum amount of the penalty.

Explanation of Provision

The Act increases the level of this penalty to one percent of the aggregate amount invested in the tax shelter (but in no event less than $500). The $10,000 cap on this penalty that existed in prior law is deleted.

Effective Date

This provision is effective for failures to register tax shelters with respect to which interests are first offered for sale after the date of enactment.

b. Penalty for failure to report the tax shelter identification number (sec. 1533 of the Act and sec. 6707(b) of the Code)[27]

Prior Law

If a taxpayer invests in a tax shelter that has a tax shelter identification number, the taxpayer is required to include that number on the taxpayer's tax return (sec. 6707(b)). Under prior law, the penalty for failure to do so was $50, unless the failure was due to reasonable cause.

Reasons for Change

In order for the tax shelter registration system to function properly, taxpayers must report the tax shelter identification numbers on their tax returns. Congress believed that the prior-law penalty for failure to do so was too low.

Explanation of Provision

The Act increases the penalty for failure to report a tax shelter identification number on a tax return from $50 to $250. The prior-law exception from the penalty where the failure to report the number is due to reasonable cause remains unchanged.

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[27] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 534; S.Rep. 99-313, p. 194; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 794-795 (Conference Report).

Effective Date

The provision is effective for tax returns filed after the date of enactment.

c. Penalty for failure to maintain lists of tax shelter investors (sec. 1534 of the Act and sec. 6708 of the Code)[28]

Prior Law

Under prior and present law, organizers and sellers of specified tax shelters are required to maintain lists of investors (sec. 6112). Under prior law, the penalty for failure to do so is $50 for each name missing from the list, unless the failure is due to reasonable cause, up to a maximum of $50,000 per year (sec. 6708).

Reasons for Change

Congress believed that the requirement that tax shelter organizers and sellers maintain lists of investors provides the IRS with an important mechanism to identify quickly all of the participants in tax-shelter investments and consequently to treat all participants more uniformly. Accordingly, Congress believed that it is appropriate to raise the maximum level of this penalty commensurate with the importance of the requirement to maintain lists of tax-shelter investors.

Explanation of Provision

The Act increases the maximum penalty that can be imposed for failure to maintain lists of tax shelter investors in any calendar year from $50,000 to $100,000. The prior-law exception from the penalty where the failure to include a name on a list is due to reasonable cause and not to willful neglect remains unchanged.

Effective Date

The increase in this penalty is effective for failures occurring or continuing after the date of enactment.

3. Tax shelter interest (sec. 1535 of the Act and sec. 6621(d) of the Code)[29]

Prior Law

Taxpayers who underpay their taxes must pay interest. If the interest is attributable to an underpayment of tax of more than $1,000 that is attributable to a tax-motivated transaction (such as a tax shelter), interest is computed at 120 percent of the generally applicable interest rate.

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[28] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 535; S.Rep. 99-313, pp. 194-195; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 795 (Conference Report).

[29] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 536; S.Rep. 99-313, p. 195; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 795-796 (Conference Report).

Reasons for Change

The Tax Court has recently held (*DeMartino* v. *Comm'r.*, T. C. Memo 1986-263 (June 30, 1986); *Forseth* v. *Comm'r.*, T. C. Memo 1985-279 (June 11, 1985)) that sham transactions that would be subject to this special interest rate were they not shams are not subject to this special interest rate because they are shams. Congress viewed it as anomalous that a genuine transaction (lacking the proper profit motive) would be subject to a higher interest rate, while a sham transaction, which is significantly more abusive, would escape the higher interest rate simply because it is a sham.

Explanation of Provision

The Act makes a technical correction to this provision that increases the rate of interest for tax-motivated transactions. The Act, consistent with the legislative intent in originally enacting section 6621(d) in 1984, explicitly adds sham or fraudulent transactions to the list of transactions subject to this higher interest rate. The intent of Congress was to reverse the holding of these Tax Court cases on this issue.

Effective Date

This clarification applies to interest accruing after December 31, 1984, which is the date this higher interest rate took effect. This clarification does not apply, however, to any underpayment with respect to which there was a final court decision (either through exhausting all appeals rights or the lapsing of the time period within which an appeal must be pursued) before the date of enactment of this Act.

Revenue Effect of Tax Shelter Provisions

These tax shelter provisions are estimated to have a negligible effect on fiscal year budget receipts.

E. Estimated Tax Payments

1. Individuals (sec. 1541 of the Act and sec. 6654 of the Code)[30]

Prior Law

Under prior and present law, individuals owing income tax who do not make estimated tax payments are generally subject to a penalty (sec. 6654). In order to avoid the penalty, prior law provided that individuals must make quarterly estimated tax payments that equal at least the lesser of 100 percent of last year's tax liability or 80 percent of the current year's tax liability. Amounts withheld from wages are considered to be estimated tax payments.

Reasons for Change

Congress believed that it is important for the proper functioning of the tax system that taxpayers be relatively current in paying their tax liability. In light of the fact that most taxpayers have taxes withheld from each paycheck and that wage withholding closely approximates tax liability[31] for many of these taxpayers, Congress believed that it is appropriate to require that taxpayers making estimated tax payments keep similarly current in their payments.

Explanation of Provision

The Act increases from 80 percent to 90 percent the proportion of the current year's tax liability that taxpayers must make as estimated tax payments in order to avoid the estimated tax penalty. The alternate test of 100 percent of the preceding year's liability remains unchanged.

Effective Date

This provision is effective with respect to taxable years beginning after December 31, 1986. Thus, the estimated tax payment due January 15, 1987, which is the final payment for taxable year 1986, is unaffected by this provision. All subsequent estimated tax payments are, however, subject to this provision.

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[30] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1311; H.Rep. 99-426, p. 837; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 561; S.Rep. 99-313, p. 196; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 797 (Conference Report).

[31] In fact, a number of these taxpayers are overwithheld. A substantial portion of overwithholding appears to occur because of taxpayer preference, however, rather than widespread defects in the withholding system.

2. Certain tax-exempt organizations (sec. 1542 of the Act and sec. 6154 of the Code)[32]

Prior Law

Under prior and present law, private foundations must pay an excise tax on their net investment income. Tax-exempt organizations are subject to tax on income from an unrelated business. Prior law provided that these taxes were to be paid when the tax returns were filed.

Under prior and present law, corporations are required to make quarterly estimated tax payments of corporate income taxes; failure to do so is subject to a penalty.

Reasons for Change

Congress believed that it is appropriate that the excise tax on net investment income of private foundations and the tax on unrelated business income of tax-exempt organizations be subject to the same estimated tax payment rules as are corporate income taxes.

Explanation of Provision

Quarterly estimated payments must be made of the excise tax on net investment income of private foundations and of the tax on unrelated business income of tax-exempt organizations. These quarterly estimated payments must be made under the same rules that apply to corporate income taxes.

Effective Date

These provisions are effective for taxable years beginning after December 31, 1986.

3. Waiver of estimated tax penalties (sec. 1543 of the Act)[33]

Prior Law

Under prior and present law, if the withholding of income taxes from wages does not cover an individual's total income tax liability, the individual, in general, is required to make estimated tax payments. Also, corporations are normally required to make quarterly estimated tax payments. An underpayment of an estimated tax installment will, unless certain exceptions are applicable, result in the imposition of an addition to tax on the amount of underpayment for the period of underpayment.

Reasons for Change

Congress believed that it is appropriate to provide relief from estimated tax penalties attributable to retroactive changes in the tax law made by the Act.

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[32] For legislative background of the provision, *see*: Senate floor amendment, 132 Cong. Rec. S8078-8079 (June 20, 1986); S8223-8224 (June 24, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 797-798 (Conference Report).

[33] For legislative background of the provision, *see*: H.Rep. 99-841, Vol. II (September 18, 1986), p. 798 (Conference Report).

Explanation of Provision

The Act makes several changes that increase tax liabilities from the beginning of 1986. Consequently, the Act allows individual taxpayers until April 15, 1987, and corporations until March 15, 1987 (the final filing dates for calendar year returns), to pay their full 1986 income tax liabilities without incurring any additions to tax on account of underpayments of estimated tax to the extent that the underpayments are attributable to changes in the law made by Act.[34]

Revenue Effect of Estimated Tax Provisions

These estimated tax provisions are estimated to increase fiscal year budget receipts by $1,522 million for 1987, $82 million for 1988, $51 million for 1989, $112 million for 1990, and $88 million for 1991.

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[34] The rule described on page 64 of volume II of the Conference Report (providing 30 days from the date of enactment to pay underpayments attributable to the repeal of the investment tax credit) is of no effect, since it is subsumed by the statutory rule described above. *See* 132 Cong. Rec. H8359 (September 25, 1986) (Statement of Mr. Rostenkowski).

F. Tax Litigation and Tax Court

1. Awards of attorney's fees in tax cases (sec. 1551 of the Act and sec. 7430 of the Code)[35]

Prior Law

The Civil Rights Attorney's Fees Awards Act of 1976

The Civil Rights Attorney's Fees Awards Act of 1976 (42 U.S.C. sec. 1988) provides, in part, that in any civil action or proceeding brought by or on behalf of the United States to enforce, or charging a violation of, a provision of the Internal Revenue Code, the court in its discretion may allow the prevailing party reasonable attorney's fees as a part of the costs. The provision does not authorize awards of attorney's fees to the United States when it is the prevailing party. Further, the provision is limited to actions brought by or on behalf of the Federal Government (that is, to cases in which the taxpayer is the defendant). Most civil tax litigation is initiated by the taxpayer who brings suit against the Government. In the United States Tax Court, the taxpayer is the petitioner in a deficiency proceeding. In the Federal district courts and the U.S. Claims Court, the taxpayer is the plaintiff suing the Government for a refund.

The Equal Access to Justice Act

In 1980, as part of Public Law 96-481, Congress enacted the Equal Access to Justice Act (28 U.S.C. sec. 2412) which, in part, authorizes awards to a prevailing party, other than the United States, of attorney's fees and other expenses, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust. This provision applies specifically to cases in Federal district courts and the United States Claims Court. However, the provision is not applicable to cases in the United States Tax Court.[36]

The Equal Access to Justice Act became effective on October 1, 1981. The provision repealed the applicability of the Civil Rights Attorney's Fees Awards Act of 1976 to tax litigation.

Under the Equal Access to Justice Act, fees and other expenses that may be awarded to a prevailing party include the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable attorney's fees. In general, no expert witness may be compensated at a rate that exceeds the highest rate of compensation for expert witnesses paid by the United States. Attorney's fees in excess of $75 per hour may not be awarded unless the court determines that a higher fee is justified.

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[35] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1315; H.Rep. 99-426, pp. 838-841; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 541; S.Rep. 99-313, pp. 197-199; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 799-802 (Conference Report).

[36] This is because the Equal Access to Justice Act is contained in Title 28 of the United States Code, which deals with courts created under Article III of the United States Constitution. The United States Tax Court is established under Article I of the United States Constitution.

Code section 7430

In general, Code section 7430 authorized the award of reasonable litigation costs, including attorney's fees and court costs, to a taxpayer who prevailed in a tax case in any Federal court. Such costs could be awarded whether the action was brought by or against the taxpayer. No award could be made to the Government if the taxpayer did not prevail, or to any creditor of a prevailing taxpayer.

Section 7430 was the exclusive provision for awards of litigation costs in any action or proceeding to which it applied.

The amount that could be awarded for litigation costs in a particular proceeding (such as a Tax Court case) could not exceed $25,000. This limitation applied regardless of the number of parties to the proceeding or the number of tax years at issue.

Section 7430 authorized an award of reasonable litigation costs only if the taxpayer established that the position of the Government in the case was unreasonable and if the taxpayer had substantially prevailed with respect to the amount in controversy or the most significant issue or set of issues presented. The determination by the court on this issue was made on the basis of the facts and legal precedents relating to the case as revealed in the record.

No award could be made unless the court determined that the taxpayer had exhausted all administrative remedies available within the Internal Revenue Service.

Section 7430, which was enacted in the Tax Equity and Fiscal Responsibility Act of 1982, became effective for cases begun after February 28, 1983. Under prior law, the provision did not apply to any proceeding commenced after December 31, 1985.

Damages assessable for instituting proceedings before the Tax Court merely for delay

Prior and present law provide that, if it appears to the Tax Court that proceedings before it have been instituted or maintained by a taxpayer primarily for delay, or that the taxpayer's position in the proceedings is frivolous or groundless, the court may award damages to the United States. These damages may not exceed $5,000 (sec. 6673).

Reasons for Change

Congress believed that the provision authorizing awards of attorney's fees should be continued but must be modified to provide greater consistency between the laws governing the awards of attorney's fees in tax and nontax cases. Specifically, Congress believed that the Equal Access to Justice Act generally provides a more appropriate standard for awarding attorney's fees in tax as well as nontax cases.

Congress, however, did not deem it appropriate to alter the burden of proof in tax cases; under the Act, the burden of proof is on the taxpayer to prove that the Government's position was not substantially justified before an award can be made. Thus, the burden of proof necessary for an award of attorney's fees in tax cases is on the same party upon whom the burden of proof rests generally in tax cases. Congress believed that it was important to place the burden of proof on the same party in all aspects of tax litigation generally.

Explanation of Provision

The Act reenacts and extends section 7430 on a permanent basis, with modifications to conform these rules on awards of attorney's fees more closely to the rules under the Equal Access to Justice Act. Consequently, the Act eliminates the $25,000 cap on the award of attorney's fees and substitutes a $75 an hour limitation on attorney's fees, unless the court determines that a higher rate is justified. To make this determination, the court may look to an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys to deal with the particular issues involved in the case. As under prior law, only reasonable litigation costs are recoverable by the taxpayer. Unlike under prior law, however, prevailing market rates are applied to determine what are reasonable expenses of expert witnesses and reasonable costs of any study, analysis, or other project necessary to the preparation of the taxpayer's case. In no event are expert witnesses to be compensated at a rate in excess of the highest rate of compensation for expert witnesses paid by the United States.

The Act also denies any award to a prevailing party who unreasonably protracts the proceedings. Although this requirement is part of the Equal Access to Justice Act, it has not previously applied to Tax Court cases. As under prior law, taxpayers must exhaust the administrative remedies available to them within the IRS in order to be eligible for an award of attorney's fees.

Congress also intended certain limitations on the eligibility of certain parties for awards of attorney's fees. These limitations would make section 7430 more consistent with the Equal Access to Justice Act. Specifically, they would not allow (with two exceptions)[37] fees to be awarded to individuals whose net worth exceeds $2 million or to businesses or organizations, including units of local government, with either a net worth exceeding $7 million or more than 500 employees. In addition, Congress intended that the time period within which a claim for attorney's fees must be made under the Equal Access to Justice Act would also be applicable to claims for attorney's fees in tax cases.[38]

The burden of proof is on the taxpayer to prove that the Government's position was not substantially justified. This replaces the standard under section 7430 of prior law that required the taxpayer to prove that the Government's position was unreasonable before the taxpayer could be awarded attorney's fees. Furthermore, the "substantially justified" standard is applicable to prelitigation actions or inaction of the District Counsel of the IRS (as well as all subsequent administrative action or inaction), as well as the litigation position of the Government. Prelitigation actions or inaction by the IRS prior to the involvement of District Counsel are not eligible as components of any attorney's fee award. The Act does not modify the prior-law requirement that, in order to be eligible to be awarded attorney's fees, the taxpayer must either substantially prevail with respect to the amount in controversy or substantially prevail with respect to the most significant issue or set of issues presented. The Act also does not modify the prior-law provision that only the taxpayer (and not the Government) may be awarded attorney's fees.

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[37] The exceptions are "that an organization described in section 501(c)(3) of the Internal Revenue Code of 1954 (26 U.S.C. 501(c)(3)) exempt from taxation under section 501(a) of such Code, or a cooperative association as defined in section 15(a) of the Agricultural Marketing Act (12 U.S.C. section 1141j(a)), may be a party regardless of the net worth of such organization or cooperative association." Such an organization or cooperative association may not recover fees if it has more than 500 employees.

[38] A technical correction may be needed so that the statute reflects this intent.

The Act further clarifies the funding of any awards under this section of the Code. Specifically, awards are payable in the case of Tax Court cases in the same manner as a similar award by a district court.

Effective Date

This provision applies to proceedings commenced after December 31, 1985, with no sunset date. However, no payments may be made as a result of this provision before October 1, 1986. The clarification making awards in Tax Court cases payable in the same manner as awards by a district court is effective for actions or proceedings commenced after February 28, 1983.

Budget Effect

This provision is estimated to increase fiscal year budget outlays by less than $5 million annually.

2. Exhaustion of administrative remedies (sec. 1552(a) and (b) of the Act and new sec. 6710 of the Code)[39]

Prior Law

Under prior and present law, taxpayers who are dissatisfied with adjustments to their tax returns proposed by the Examination personnel of the IRS can take their cases immediately to the United States Tax Court rather than appeal administratively within the IRS.

Reasons for Change

The Tax Court inventory has risen dramatically over the past ten years. One factor contributing to this increase has been the practice of taxpayers petitioning their cases directly to the Tax Court without attempting to settle the dispute with the Appeals Division of the IRS. The Appeals Division has more authority to settle cases than the Examination Division of IRS. Appeals regularly settles large numbers of cases based on the hazards of litigation. Many of the cases taken directly to the Tax Court are eventually settled by the Appeals Officers after the case has been opened in the Tax Court with little involvement by the Court.

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[39] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1316(a)-(c); H.Rep. 99-426, pp. 841-842; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 802-803 (Conference Report).

Congress consequently believed that it is appropriate to provide a penalty for failure to exhaust administrative remedies. This new penalty allows the Tax Court to penalize taxpayers who needlessly involve the Court in a dispute that should have been resolved in the Appeals Division of the IRS.

Explanation of Provision

The Act provides that failure by a taxpayer to exhaust administrative remedies is an additional basis that the Tax Court may consider in imposing the section 6673 penalty for dilatory or frivolous proceedings in the Tax Court.

Effective Date

This provision applies to proceedings commenced in the Tax Court after the date of enactment.

3. Report on Tax Court inventory (Sec. 1552(c) of the Act)[40]

Prior Law

No provision required a periodic report from the Tax Court and the IRS on the Tax Court inventory.

Reasons for Change

Congress believed that requiring a periodic report would keep it apprised of the measures that both the IRS and the Tax Court are taking to reduce the Tax Court inventory.

Explanation of Provision

The Act requires separate reports from both the IRS and the Tax Court indicating the actions taken to deal with the Tax Court inventory by closing cases more efficiently.

Effective Date

The reports are due every two years, beginning with 1987.

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[40] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1316(d); H.Rep. 99-426, pp. 841-842; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 803 (Conference Report).

4. Tax Court provisions

a. Tax Court practice fee (sec. 1553 of the Act and new sec. 7475 of the Code)[41]

Prior Law

Under prior and present law, the Tax Court imposes a $25 application fee prior to admission to practice before the Court (Tax Court Rule 200). Prior law did not authorize the imposition of any fee after the application fee has been paid.

Under prior and present law, the Tax Court rules authorize the Court to initiate disciplinary proceedings against practitioners who appear before it (Tax Court Rule 202). The Court is authorized to appoint independent counsel to pursue disciplinary matters.

Reasons for Change

Congress believed that it is appropriate to permit the Tax Court to impose a practice fee, the proceeds of which are to be used to pay outside counsel to pursue disciplinary matters.

Explanation of Provision

The Act authorizes the Tax Court to impose a periodic registration fee on practitioners admitted to practice before it. The Tax Court is to establish the level of the fee and the frequency of its collection, but the fee may not exceed $30 per year. These funds are available to the Tax Court to pay independent counsel engaged by the Court to pursue disciplinary matters.

Effective Date

This provision is effective January 1, 1987.

b. Clarification of jurisdiction over penalty for failure to pay tax (sec. 1554 of the Act and sec. 6214 of the Code)[42]

Prior Law

The Tax Court has held that it does not have jurisdiction over the addition to tax for failure to pay the amount of tax shown on the taxpayer's return, even though it has jurisdiction to redetermine a deficiency in tax with respect to that return (*Est. of Young* v. *Comm'r.*, 81 T.C. 879 (1983)).

Reasons for Change

Congress believed that it is appropriate for the Tax Court to have jurisdiction over this addition to tax if it already has jurisdiction with respect to a deficiency in tax relating to that tax return.

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[41] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 542; S.Rep. 99-313, pp. 199-200; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 803-804 (Conference Report).

[42] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 543; S.Rep. 99-313, p. 200; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 804 (Conference Report).

Explanation of Provision

The Act provides that the Tax Court has jurisdiction over this addition to tax for failure to pay an amount shown on the return where the Tax Court already has jurisdiction to redetermine a deficiency in tax with respect to that return.

Aside from resolving this jurisdictional issue, the provision does not alter the jurisdiction of the Tax Court. The amendment was not intended to change prior law insofar as (1) the section 6651(a)(1) late filing addition to tax, or (2) the procedure for assessing additions to tax under section 6662(b) is concerned.

Effective Date

This provision is effective for any action or proceeding before the Tax Court which has not become final before the date of enactment.

c. U.S. Marshals (sec. 1555 of the Act and sec. 7456 of the Code)[43]

Prior Law

United States Marshals provide courtroom security, among other duties. Under prior law, it was not clear that the Tax Court had the authority to request the assistance of U.S. Marshals, because the Tax Court is an Article I (rather than Article III) court.

Reasons for Change

Congress believed that it is vital that the Tax Court be able to request the assistance of U.S. Marshals to provide courtroom security for the Tax Court.

Explanation of Provision

The Act requires that the U.S. Marshal for any district in which the Tax Court is sitting must attend any session of the Tax Court, when requested to do so by the Chief Judge of the Tax Court.

Effective Date

This provision is effective on the date of enactment of the Act.

d. Special Trial Judges (sec. 1556 of the Act and new sec. 7443A of the Code)[44]

Prior Law

Under prior and present law, the Chief Judge of the Tax Court is authorized to appoint Special Trial Judges, who assist in the work of the Court. Prior law provided that their salary was determined by the procedures relating to the Commission on Executive, Legislative, and Judicial Salaries. The Executive Order implementing that provision failed to include Special Trial Judges.

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[43] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 544; S.Rep. 99-313, p. 201; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 804-805 (Conference Report).

[44] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 545; S.Rep. 99-313, pp. 201-202; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 805 (Conference Report).

Prior to January 17, 1985, Special Trial Judges were entitled to reimbursement for travel expenses on the same basis as other Federal judges. On that date, the Comptroller General determined that they were entitled only to reduced reimbursement pursuant to the Federal Travel Regulations.

Reasons for Change

Congress believed that, in view of the vital role that the Special Trial Judges have, it is important to clarify these provisions.

Explanation of Provision

The Act consolidates in one new section of the Code a number of the provisions relating to the Special Trial Judges. The Act also specifies that Special Trial Judges are to be paid 90 percent of the salary paid to Tax Court Judges, and that Special Trial Judges are to be reimbursed for travel and subsistence expenses to the same extent as are Tax Court Judges.

Effective Date

Generally, these provisions are effective on the date of enactment. The provision relating to the salary of Special Trial Judges is effective on the first day of the first month beginning after the date of enactment.

e. Election to practice law after retirement and receive retirement pay (sec. 1557 of the Act and secs. 7447 and 7448 of the Code)[45]

Prior Law

Prior and present law provide that United States District Court judges meeting age and longevity of tenure requirements may resign, engage in the practice of law, and continue to receive retirement pay. This retirement pay is not, however, adjusted to reflect changes in the pay of active District Court judges.

Prior law provided that retired Tax Court judges who engaged in the practice of Federal tax law forfeited all retirement pay. Forfeiture also occurred if a retired Tax Court judge accepted another Government position, whether compensated or not.

Reasons for Change

Congress believed that it is appropriate for Tax Court judges to be able to choose to resign and practice law on the same basis that United States District Court judges are eligible to do.

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[45] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 546; S.Rep. 99-313, p. 202; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 805-806 (Conference Report).

Explanation of Provision

The Act permits Tax Court judges meeting specified age and tenure requirements to elect to receive full retired pay as of the date they make the election (which would not be adjusted to reflect changes in the pay of active Tax Court judges) and not be subject to the prohibition on practicing tax law. The Act also suspends retired pay for the period of time during which a retired Tax Court judge holds a compensated Government position.

Effective Date

This provision generally is effective on the date of enactment.

f. Appeals from interlocutory orders (sec. 1558 of the Act and sec. 7482 of the Code)[46]

Prior Law

The Second Circuit has held that the United States Courts of Appeals do not have jurisdiction over any interlocutory order issued by the Tax Court (*Shapiro* v. *Comm'r.*, 632 F.2d 170 (2d Cir. 1980)).

Reasons for Change

Congress believed that it is appropriate that a party be able to pursue an appeal from an interlocutory order in Tax Court litigation, parallel to the procedure available for district court litigation.

Explanation of Provision

The Act authorizes an appeal from an interlocutory order of the Tax Court if a judge of the Tax Court includes in an interlocutory order a statement that a controlling question of law is involved, that there is substantial ground for difference of opinion regarding the question of law, and that an immediate appeal from the order might materially advance the ultimate termination of the litigation. Congress expected that this provision would only be used in those relatively rare instances in which these conditions are fully satisfied.

The Court of Appeals is given discretion as to whether or not to permit the appeal. Neither the application for nor the granting of an appeal stays proceedings in the Tax Court unless a stay is ordered by either the Tax Court or the Court of Appeals.

Effective Date

This provision applies to any order of the Tax Court entered after the date of enactment.

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[46] For legislative background of the provision, *see*: H.Rep. 99-841, Vol. II (September 18, 1986), p. 806 (Conference Report).

g. Annuities for surviving spouses and dependent children of Tax Court judges (sec. 1559 of the Act and sec. 7448 of the Code)[47]

Prior Law

Prior law permitted Tax Court judges to elect to have 3 percent of their salary deducted to fund an annuity for their surviving spouses and dependent children. The survivors annuity provisions relating to other Federal judges were recently updated (P.L. 99-335, June 6, 1986); the survivors annuity provisions relating to Tax Court judges were not updated at the same time.

Reasons for Change

Congress believed that it is appropriate that the survivors annuity provisions relating to Tax Court judges be parallel to those applicable to other Federal judges.

Explanation of Provision

The Act makes the survivors annuity provisions relating to Tax Court judges parallel to those applicable to other Federal judges.

Effective Date

This provision is generally effective on November 1, 1986.

Revenue Effect of Items 2, 3, and 4

These tax litigation and Tax Court provisions are estimated to have a negligible effect on fiscal year budget receipts.

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[47] For legislative background of the provision, *see*: H.Rep. 99-841, Vol. II (September 18, 1986), p. 807 (Conference Report).

G. Tax Administration Provisions

1. Suspend statute of limitations during prolonged dispute over third-party records (sec. 1561 of the Act and sec. 7609 of the Code)[48]

Prior Law

Under prior and present law, there is generally a three-year statute of limitations on tax returns, except in cases of fraud, failure to file, or a sizeable understatement of income (sec. 6501). Under prior law, the statute continued to run even if the IRS was required to obtain records held by third parties.[49] Consequently, if the IRS litigated to obtain access to the third-party records, the statute of limitations could have expired prior to final determination as to the availability of the records.

Reasons for Change

In general, IRS requests for access to third-party records are resolved relatively expeditiously. This is generally true because most third-party recordkeepers have no independent motivation to prolong the dispute with the IRS. In certain instances, however, a few third-party recordkeepers have prolonged these disputes with the IRS. Their motivation appears to have been to protect the interests of their clients by prolonging the litigation over the records sufficiently so that the statute of limitations expires during the dispute.

Congress believed that it is inappropriate for a third party to prolong litigation with the IRS so as to permit the statute of limitations to expire with respect to the taxpayer whose records are being sought. Consequently, the Act suspends the statute of limitations if the third party records are not produced within six months of the issuance of an administrative summons. Congress anticipated that this provision will rarely need to be utilized, since most disputes with third-party recordkeepers are resolved within six months of the issuance of an administrative summons.

Explanation of Provision

If the dispute between the third-party recordkeeper and the IRS is not resolved within six months after the IRS issues an administrative summons, the statute of limitations is suspended until the issue is resolved. The issue is not considered to be resolved during the pendency of any action to compel production of the documents.

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[48] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 556; S.Rep. 99-313, pp. 206-207; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 809 (Conference Report).

[49] The statute is, however, suspended if the taxpayer intervenes in the dispute between the IRS and the third-party recordkeeper (sec. 7609(e)).

The third-party recordkeeper is also required to provide notice of the suspension of the statute of limitations to the taxpayer whose records are the subject of the dispute if the summons requesting the records does not identify the taxpayer by name. Failure by the third party to do so does not prevent the suspension of the statute.

Also, as was the case under prior law, the statute of limitations is suspended during the period when a taxpayer intervenes in a dispute between the IRS and a third-party recordkeeper. The statute is suspended from that date until the entire dispute is resolved.

Effective Date

This provision is effective on the date of enactment.

2. Authority to rescind statutory notice of deficiency (sec. 1562 of the Act and sec. 6212 of the Code)[50]

Prior Law

Under prior law, once the IRS issued a statutory notice of deficiency (90-day letter), the IRS did not have the authority to withdraw the letter. The statutory notice is a jurisdictional prerequisite to petitioning the Tax Court for review of the IRS determination; the notice must be issued before the expiration of the statute of limitations. Once the notice has been issued, only a Tax Court decision can alter its effect.

Reasons for Change

In a number of cases, both the IRS and the taxpayer would prefer that the statutory notice be withdrawn so that the matter can be disposed of administratively without the involvement of the Tax Court. Therefore, Congress determined that it is appropriate, where both the IRS and the taxpayer agree, to permit withdrawal of the statutory notice. This will permit the matter to be disposed of in the most efficient way.

Explanation of Provision

Where the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded. Once the notice has been properly rescinded, it is treated as if it never existed. Therefore, limitations regarding credits, refunds, and assessments relating to the rescinded notice are void and the parties are returned to the rights and obligations existing prior to the issuance of the withdrawn notice. Also, the IRS may issue a later notice for a deficiency greater or less than the amount in the rescinded notice.

Under Code section 7805, the Secretary has the authority to establish by regulation the procedures necessary to implement the withdrawal of notice provision to assure that the taxpayer has consented to the withdrawal of the statutory notice. The regulations should also clarify the effect of rescission on other provisions of the Code.

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[50] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1321; H.Rep. 99-426, p. 843; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 551; S.Rep. 99-313, p. 207; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 810 (Conference Report).

Effective Date

This provision is effective for statutory notices of deficiency issued on or after January 1, 1986.

3. Authority to abate interest due to errors or delay by the IRS (sec. 1563 of the Act and sec. 6404 of the Code)[51]

Prior Law

Under prior law, the IRS did not generally have the authority to abate interest charges where the additional interest was caused by IRS errors and delays. This resulted from the IRS' long-established position that once tax liability is established, the amount of interest is merely a mathematical computation based on the rate of interest and due date of the return. Consequently, the interest portion of the amount owed to the Government could not be reduced unless the underlying deficiency was reduced. The IRS does, however, under prior and present law, have the authority to abate interest resulting from a mathematical error of an IRS employee who assists taxpayers in preparing their income tax returns (sec. 6404(d)).

Reasons for Change

In some cases, the IRS has admitted that its own errors or delays have caused taxpayers to incur substantial additional interest charges. This may even occur after the underlying tax liability has been correctly adjusted by the IRS or admitted by the taxpayer. Congress believed that where an IRS official acting in his official capacity fails to perform a ministerial act after contacting the taxpayer in writing, such as issuing either a statutory notice of deficiency or notice and demand for payment after all procedural and substantive preliminaries have been completed, authority should be available for the IRS to abate the interest independent of the underlying tax liability.

Explanation of Provision

In cases where an IRS official fails either to perform a ministerial act in a timely manner or makes an error in performing a ministerial act, the IRS has the authority to abate the interest attributable to such error or delay. No significant aspect of the error or delay can be attributable to the taxpayer. The Act gives the IRS the authority to abate interest but does not mandate that it do so (except that the IRS must do so in cases of certain erroneous refunds of $50,000 or less, described below). Congress did not intend that this provision be used routinely to avoid payment of interest; rather, it intended that the provision be utilized in instances where failure to perform a ministerial act results in the imposition of interest, and the failure to abate the interest would be widely perceived as grossly unfair. The interest abatement only applies to the period of time attributable to the failure to perform the ministerial act.

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[51] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1322; H.Rep. 99-426, pp. 844-845; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 552; S.Rep. 99-313, pp. 208-209; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 810-811 (Conference Report).

The provision applies only to failures to perform ministerial acts that occur after the IRS has contacted the taxpayer in writing. This provision does not therefore permit the abatement of interest for the period of time between the date the taxpayer files a return and the date the IRS commences an audit, regardless of the length of that time period. Similarly, if a taxpayer files a return but does not pay the taxes due, this provision would not permit abatement of this interest regardless of how long the IRS took to contact the taxpayer and request payment.

Congress intended that the term "ministerial act" be limited to a nondiscretionary act when all of the prerequisites to the Act, such as fact gathering, analysis, decision-making, and conferencing and review by supervisors, have taken place. Thus, a ministerial act is a routine procedural action, not a decision in a substantive area of tax law (or any other applicable law). For example, a substantial and unusual delay in the issuance of a statutory notice of deficiency after the IRS and the taxpayer have completed efforts to resolve the matter could be grounds for abatement of interest.

The IRS must abate interest in certain instances in which it issues an erroneous refund check. For example, the IRS may make an error that causes a taxpayer to get a refund check for $1,000 instead of the $100 that the taxpayer rightfully claimed. In the past, the IRS charged the taxpayer interest on the $900 for the time period that the taxpayer held that money.

Congress believed that it is generally inappropriate to charge taxpayers interest on money they temporarily have because the IRS has made an error. Consequently, the IRS may not charge interest on these erroneous refunds until the date it demands repayment of the money. There are two limitations on this rule. First, it is not to apply in instances in which the taxpayer (or a related party) has in any way caused the overstated refund to occur. Second, it is not to apply to any erroneous refund checks that exceed $50,000. If the taxpayer does not repay the erroneous refund when requested to do so by the IRS, interest would then begin to apply to the amount of the erroneous refund.

Effective Date

This provision is effective for interest accruing with respect to deficiencies or payments for taxable years beginning after December 31, 1978.

4. Suspension of compounding where interest on deficiency is suspended (sec. 1564 of the Act and sec. 6601 of the Code)[52]

Prior Law

Under prior law, in the case of a deficiency in income, estate, gift, and certain excise taxes, a waiver of restrictions on assessment of the deficiency is filed when the IRS and the taxpayer agree on the proper amount of tax due at the conclusion of an audit. If, however, the Secretary fails to make notice and demand for payment within 30 days after the filing of the waiver, interest is not imposed on the deficiency from the 31st day after the waiver was filed until the date the notice and demand is issued. This provision does not, however, suspend the compounding of interest for the same period on the interest which previously accrued on the underlying deficiency.

Reasons for Change

The intent of the present-law provision is to suspend the running of interest where the IRS fails to issue the taxpayer a bill stating how much the taxpayer owes within 30 days after the conclusion of an audit, if the taxpayer files a waiver of the restrictions on assessment. Congress believed that it is appropriate to apply the same principle to the compounding of interest on previously accrued interest.

Explanation of Provision

Both the interest on the deficiency as well as the compounded interest on the previously accrued interest are suspended, starting 31 days after a taxpayer has filed a waiver of restrictions on assessment of the underlying taxes and ending when a notice and demand is issued to the taxpayer.

Effective Date

This provision is effective for interest accruing in taxable periods after December 31, 1982. Taxpayers may obtain refunds of interest subject to this provision that they paid by filing a claim for refund of their interest with the IRS. The IRS presently does not possess the data processing capability to suspend the compounding of interest on previously accrued interest. Taxpayers who consider themselves entitled to the relief provided by this provision may apply to the IRS, and, in appropriate cases, the IRS will perform the required computations.

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[52] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1323; H.Rep. 99-426, pp. 845-846; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 553; S.Rep. 99-313, pp. 209-210; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 812 (Conference Report).

5. Exemption from levy for service-connected disability payments (sec. 1565 of the Act and sec. 6334 of the Code)[53]

Prior Law

Under prior and present law, various payments, such as unemployment benefits, workmen's compensation, a minimum amount of ordinary wages, as well as certain pensions and annuities, are exempt from levy. This means that the IRS cannot seize these payments to collect delinquent taxes by serving a levy on the payment source. The IRS can collect the delinquent taxes from other nonexempt sources available to the delinquent taxpayer.

Reasons for Change

Congress believed that various military service-connected disability payments should be exempt from levy, just as other similar payments are exempt from levy.

Explanation of Provision

The IRS is prohibited from levying on any amount payable to an individual as a service-connected disability benefit under specified provisions of Title 38 of the United States Code.

The term "service-connected" means that the disability was incurred or aggravated in the line of duty in the active military, naval, or air service. The exemption covers direct compensation payments, as well as other types of support payments for education and housing.

Effective Date

This provision is effective for payments made after December 31, 1986.

6. Modification of administrative rules applicable to forfeiture (sec. 1566 of the Act and sec. 7325 of the Code)[54]

Prior Law

Under prior and present law, the IRS can seize property that is used in violating the provisions of the Internal Revenue laws. Under prior law, if the amount of personal property seized is valued at $2,500 or less, the IRS may use administrative procedures to forfeit the property and sell it without judicial action, after both appraisal and notice to potential claimants. A claimant may post a bond of $250 and require the Government to proceed by judicial action to sell the property. These procedures are separate and distinct from those the IRS uses for routine collection of past-due taxes.

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[53] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1324; H.Rep. 99-426, pp. 846-847; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 554; S.Rep. 99-313, pp. 210-211; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 812-813 (Conference Report).

[54] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1325; H.Rep. 99-426, p. 847; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 813 (Conference Report).

Reasons for Change

Congress believed that the dollar values in this forfeiture provision are too low,[55] and should be raised to the levels that apply in Customs cases.[56] Congress believed that the administrative forfeiture procedures are more efficient than judicial ones and, where no claimants exist, will eliminate the unnecessary involvement of the judiciary. If a claimant exists, the Act continues to permit the claimant to require (after posting a bond) a judicial proceeding to implement the forfeiture.

Explanation of Provision

The Act allows the Treasury to sell administratively up to $100,000 of personal property used in violation of the Internal Revenue laws. Such sale would require both an appraisal to determine value and a notice by newspaper publication to potential claimants. Potential claimants can require a judicial forfeiture action by posting a $2,500 bond.

Effective Date

This provision is effective on the date of enactment.

7. Certain recordkeeping requirements (sec. 1567 of the Act)[57]

Prior Law

In general, certain use of Government-provided law enforcement vehicles by law enforcement officers is not subject to the substantiation rules of section 274(d), and the value of this use is not includible in the income or wages of the officers (under sec. 132). The conference report on the repeal of the contemporaneous recordkeeping requirements for automobiles[58] provided that IRS special agents are not to be included within the term "law enforcement officers."

Reasons for Change

Congress believed that it is appropriate to treat IRS special agents in the same manner as other law enforcement officers are treated.

Explanation of Provision

The Act provides that, for purposes of sections 132 and 274, use of an automobile by a special agent of the IRS is treated in the same manner as use of an automobile by an officer of any other law enforcement agency.

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[55] The $2,500 amount was last increased in 1958 (sec. 204 of the Excise Tax Technical Changes Act of 1958 (P.L. 85-859)); the $250 amount was in the Internal Revenue Code of 1954 as originally enacted.

[56] *See* 19 U.S.C. secs. 1607, 1608.

[57] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1326; H.Rep. 99-426, pp. 847-848; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 555; S.Rep. 99-313, p. 211; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 814 (Conference Report).

[58] H.Rep. 99-67 (May 7, 1985).

Effective Date

The provision is effective beginning after December 31, 1984.

8. Disclosure of return information to certain cities (sec. 1568 of the Act and sec. 6103 of the Code)[59]

Prior Law

Section 6103 provides for the confidentiality of returns and return information of taxpayers. The conditions under which returns and return information can be disclosed are specifically enumerated in that section. Under prior law, disclosure of returns and return information to local income tax administrators was not permitted. Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than 5 years, or both, under section 7213. An action for civil damages may also be brought for unauthorized disclosure under section 7431.

Reasons for Change

Congress wanted to enable large cities that impose an income or wage tax to receive returns and return information in the same manner, and with the same safeguards, as States are eligible to do.

Explanation of Provision

The Act provides that any city with a population in excess of 2 million that imposes an income or wage tax may, if the Secretary in his sole discretion[60] so provides, receive returns and return information for the same purposes for which States may obtain information under prior and present law, subject to the same safeguards as apply to States under prior and present law. Cities that receive information must reimburse the Internal Revenue Service for its costs in the same manner as a State must under prior and present law. Population is determined on the basis of the most recent decennial United States census data available.

Any disclosure would be required to be in the same manner and with the same safeguards as disclosure is made to a State. The prior- and present-law requirements of maintaining a system of standardized requests for information and the reasons for the request and of maintaining strict security against release of the information are also made applicable to the local agencies. Disclosure is permitted only for the purpose of, and only to the extent necessary in, the administration of a local jurisdiction tax. Disclosure of returns or return information to any elected official or the chief official (even if not elected) of the local jurisdiction is not permitted. Any unauthorized disclosure of returns and return information by an employee of an agency receiving this information subjects the employee to the fine and imprisonment provided by section 7213 and to the civil action provided by section 7431.

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[59] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 557; S.Rep. 99-313, pp. 212-213; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 814-815 (Conference Report).

[60] The Secretary may, in accordance with this discretion, implement this provision on a trial basis.

Effective Date

This provision is effective on the date of enactment.

9. Priority of local law in certain forfeitures (sec. 1569 of the Act and sec. 6323 of the Code)[61]

Prior Law

Under prior and present law, if a person owing tax fails to pay that tax, a lien is created on all the taxpayer's property at the time of assessment. Under prior law, this lien took priority over any other attachment to the taxpayer's property that had not been perfected at the time of assessment. Thus, under State law in a number of States, a State law enforcement agency may perform an extensive investigation of an individual, leading to the seizure and forfeiture of that individual's property. If the State has cooperated with the IRS and the IRS files a lien, the IRS lien may take priority over the State's claim to the property.

Reasons for Change

Congress believed that prior law may have deterred some State or local law enforcement agencies from fully cooperating with the IRS.

Explanation of Provision

The Act provides that a forfeiture under local law of property seized by a law enforcement agency of either a State or a political subdivision of a State relates back to the time of seizure. The provision does not apply to the extent that local law provides that someone other than the governmental unit has priority over the governmental unit in the property. For purposes of this provision, a State or local tax agency is not considered to be a law enforcement agency.

Effective Date

This provision is effective on the date of enactment.

10. Release of certain seized property to the owner (sec. 1570 of the Act and sec. 6335 of the Code)[62]

Prior Law

Under prior and present law, the Federal Government has the power, after proper notice and demand, to seize and sell the property of a delinquent taxpayer. As soon as practicable after seizure, the Government is required to give written notice of the seizure to the owner of the property. This notice must describe the property seized and specify the sum of money owed and demanded for release of the property. The Government also must give notice of the sale of the seized property to its owner as soon as practicable after seizure. This notice must specify the property to be sold as well as the time, place, manner, and conditions of the sale.

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[61] For legislative background of the provision, *see*: H.Rep. 99-841, Vol. II (September 18, 1986), pp. 815-816 (Conference Report).

[62] For legislative background of the provision, *see*: H.Rep. 99-841, Vol. II (September 18, 1986), pp. 816-817 (Conference Report).

Before the sale, the Government is required to set a minimum price for the property, taking into account the expenses to the Government of the levy and sale. At the sale, the property is sold to the highest bidder who meets or exceeds the minimum price. Under prior law, if no bid met or exceeded the minimum price, the property was deemed to be sold to the Government for the minimum price. Thus, the Government had no discretion under prior law in purchasing the property itself when no bid met or exceeded the minimum price.

Reasons for Change

Congress believed that the IRS should have discretion to determine whether purchasing the property is in the best interests of the Government, while at the same time preserving the Government's ability to collect taxes that are due.

Explanation of Provision

The Act requires that, before the sale of the property, the IRS determine (based upon criteria prescribed by the Treasury) whether the purchase of the property at the minimum price is in the best interests of the Federal Government. Property would continue to be sold to the highest bidder who meets or exceeds the minimum price.

If no bid meets or exceeds the minimum price, the Government would purchase the property at the minimum price only if the purchase were in its best interests. If the purchase were determined not to be in the best interests of the Government, the property would be released back to the owner. The property would still be subject to a Government lien. Also, any expense of the levy and sale would be added to the amount of delinquent taxes due.

Effective Date

The provision is effective for sales of seized property conducted after the date of enactment.

11. Allocation of employee tips (sec. 1571 of the Act)[63]

Prior Law

Under prior and present law, employers are required, under certain circumstances, to provide an information report of an allocation of tips in large food or beverage establishments (defined generally to include those establishments that normally employ more than 10 employees). Under this provision, if tipped employees of large food or beverage establishments report tips aggregating 8 percent or more of the gross receipts of the establishment, then no reporting of a tip allocation is required. However, if this 8-percent reporting threshold is not met, the employer must allocate (as tips for information reporting purposes) an amount equal to the difference between 8 percent of gross receipts and the aggregate amount reported by employees. This allocation may be made pursuant to an agreement between the employer and employees or, in the absence of such an agreement, according to Treasury regulations.

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[63] For legislative background of the provision, *see*: H.Rep. 99-841, Vol. II (September 18, 1986), pp. 817-818 (Conference Report).

These Treasury regulations[64] provide that this allocation may be made by the employer in either of two ways. One is to allocate based on the portion of the gross receipts of the establishment attributable to the employee during a payroll period. The second is to allocate based on the portion of the total number of hours worked in the establishment attributable to the employee during a payroll period. Under prior law, this latter method was available to all establishments, regardless of size.

Reasons for Change

Congress believed that the method of tip allocation based on the number of hours worked could unfairly allocate tips among employees, because the amount of tips is not spread evenly throughout all the hours an establishment is open for business. At the same time, Congress recognized that eliminating this method entirely could pose a significant administrative burden on small employers. Consequently, Congress repealed this method, but only for relatively sizeable establishments.

Explanation of Provision

The Act provides that the method of tip allocation based on the number of hours worked may be utilized only by an establishment that employs less than the equivalent of 25 full-time employees during a payroll period. Establishments employing the equivalent of 25 or more full-time employees would consequently have to use the portion of gross receipts method to allocate tips during the payroll period (absent an agreement between the employer and employees).

Effective Date

This provision is effective for any payroll period beginning after December 31, 1986.

12. Treatment of forfeitures of land sales contracts (sec. 1572 of the Act and sec. 7425 of the Code)[65]

Prior Law

Generally, before Federal tax liens can be extinguished, notice must be given to the Government. Several cases have held (*Runkel* v. *United States*, 527 F.2d 914 (9th Cir. 1977); *Brookbank* v. *Hubbard*, 712 F.2d 399 (9th Cir. 1983)) that forfeitures of land sales contracts are not subject to these notice requirements. Notice provides the Government with the opportunity to redeem the property.

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[64] *See* Treas. Reg. sec. 31.6053-3.

[65] For legislative background of the provision, *see*: H.Rep. 99-841, Vol. II (September 18, 1986), p. 818 (Conference Report).

Reasons for Change

Congress believed that sound tax administration principles require that the Government receive notice of these types of forfeitures.

Explanation of Provision

The Act provides that forfeitures of land sales contracts are subject to these notification requirements. Thus, these cases are explicitly overturned as to this issue. The effect of this provision is to provide the Government with both notice and the opportunity to redeem the property, which it currently has with respect to most other transfers of real estate.

Effective Date

The provision is effective for forfeitures after the 30th day after the date of enactment.

Revenue Effect of Tax Administration Provisions

These tax administration provisions are estimated to have a negligible effect on fiscal year budget receipts.

H. Modification of Withholding Schedules (sec. 1581 of the Act and sec. 3402 of the Code)[66]

Prior Law

Prior and present law require that the Secretary prescribe tables and computational procedures for determining the appropriate amount of taxes to be deducted and withheld from wages (sec. 3402(a)). Form W-4 is the form that enables that calculation to be performed. It is completed by the employee, who furnishes it to the employer. The employer uses this form to determine the proper level of wage withholding. The employer does this by using tables issued by the Secretary that specify the proper amount of withholding, considering the employee's wage level and number of withholding allowances claimed.

The employee completes the Form W-4 by determining the proper number of withholding allowances (or exemptions) to which he is entitled. Withholding allowances may be claimed for the employee and any dependents (sec. 3402(f)) and for itemized deductions and estimated tax credits (sec. 3402(m)). Other items prescribed in regulations may also be claimed. For example, the regulations issued under prior law permit IRA contributions and the tax savings attributable to income averaging to be considered (*see* Treas. Reg. sec. 31.3402(m)-1). Under prior law, an employee's Form W-4 generally remained in effect until the employee revoked it and filed a new one.[67]

The IRS had the authority under prior law to issue regulations permitting employees to request, once the amount of their withholding has been determined on the basis of Form W-4 and the withholding tables, that that amount of withholding be increased or decreased. The IRS has long permitted taxpayers to request increases in withholding; the IRS has never permitted taxpayers to request decreases in withholding.

Reasons for Change

Other provisions of the Act affect the wage withholding system in two ways. First, the Act alters several of the provisions of the Code relating to itemized deductions, tax credits, and other items that were permitted to be considered in computing withholding allowances. Forms W-4 that claim withholding allowances with respect to any of these altered provisions are inaccurate. For example, a Form W-4 that claims allowances for income averaging (which is repealed elsewhere in the Act) is inaccurate, in that it claims excessive allowances.

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[66] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1335; H.Rep. 99-426, pp. 852-854; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 562; S.Rep. 99-313, pp. 214-216; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 819-820 (Conference Report).

[67] The employer is required to furnish copies of certain Forms W-4 to the IRS, such as those that claim more than a specified number of allowances or that claim total exemption from withholding (where wages are above $200 per week). Treas. Reg. sec. 31.3402(f)(2)-1(g). The IRS examines these forms, and if, after contacting the employee, it determines that a claim of withholding allowances cannot be justified, it notifies the employer to change the employee's withholding.

Second, the Act affects the tables issued by the Secretary that are used by employers to determine the proper amount of withholding. The Act affects these tables primarily by altering the tax rates and brackets. In addition, the Act increased the value of personal exemptions, which affects the value of withholding allowances.

Congress consequently determined that, in light of the major modifications that are made in this Act to the entire income tax system, the wage withholding system needed to be modified. Congress believed that these major changes make it necessary for employees to file revised Forms W-4.

Explanation of Provision

The Act requires that employees file a revised Form W-4 before October 1, 1987. They must do so on a Form W-4 that has been revised by the IRS to reflect the changes in the Code made by this Act.[68] If an employee does not file a revised Form W-4 by that date, the employer must withhold income taxes as if the employee claimed one allowance (if the employer checked the "Single" box on the most recent Form W-4 that the employee filed) or two allowances (if the employee checked the "Married" box).

The Act also requires that the IRS and Treasury modify the withholding schedules under section 3402 to approximate more closely tax liability under the amendments made by the Act. Congress expected that this modification will affect at least two major items. First, Form W-4 is to be modified. Second, the withholding tables used by employers to determine the proper amount of wage withholding are also to be modified.

With respect to modifying Form W-4, Congress expected that the IRS would make every effort to notify taxpayers that Form W-4 has been modified and that taxpayers must file the modified form with their employers before October 1, 1987. In addition, Congress expected that the IRS would issue the revised Form W-4 well before that date, to minimize the inconvenience of filing new forms for both employers and employees.

The modified form and tables should be designed so that withholding from taxpayer's wages approximates as closely as possible the taxpayer's ultimate tax liability. While Congress recognized that it is impossible to accomplish this goal with absolute precision in the case of each taxpayer, it is nonetheless vital to the integrity of the tax system that the amount withheld from wages closely match the taxpayer's ultimate tax liability. While Congress recognized that substantial involuntary overwithholding is undesirable,[69] Congress also recognized that substantial underwithholding creates significant collection and enforcement problems.

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[68] It is also permissible for employees to fulfill the requirements of this provision by filing on a substitute Form W-4 provided by the employer, so long as that form has been revised to parallel the official form and the substitute form complies with all IRS requirements pertaining to substitute Forms W-4.

While Congress believed that the changes in the substantive tax law made by the Act will permit wage withholding to approximate tax liability more closely for many taxpayers, Congress believed that increased complexity in the current Form W-4 and wage withholding tables is not desirable, even if it were designed to permit withholding to approximate tax liability more closely. Consequently, neither Form W-4 nor the wage withholding tables is to be made more complex when they are revised in accordance with this provision of the Act.

The Act also repeals the provision of prior law giving the IRS authority to issue regulations permitting employees to request decreases in withholding. The provision relating to increases in withholding is unaffected.

Effective Date

The provision requiring employees to file new Forms W-4 is effective for wages paid after September 30, 1987. The provision relating to decreases in withholding is effective on the date of enactment.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $1,007 million in 1988, $61 million in 1989, $177 million in 1990, and $195 million in 1991.

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[69] A significant portion of overwithholding appears to be attributable to taxpayer preference.

I. Report on the Return-Free System (Sec. 1591 of the Act)[70]

Prior Law

Taxpayers are generally required to file a paper document as their individual income tax return for the taxable year. These forms are currently the Form 1040 ("the long form"), the Form 1040A ("the short form"), and the recently created Form 1040EZ. In addition, the IRS is experimenting with magnetic tape return filing that allows approved return preparers to volunteer to file individual tax returns that they prepare with the IRS in a magnetic tape format. The return preparer retains the paper version of the tax return.

Reasons for Change

The ever-increasing paperwork burden on the Internal Revenue Service, the improved capabilities of computerized data processing, and expanded information reporting suggest that it may be possible to develop a return-free system for individuals. This system would relieve eligible taxpayers of most of the burden and expense of return preparation. Also, it would significantly reduce the volume of tax returns filed with the IRS. Consequently, Congress believed that it is appropriate to study the possibility of implementing the return-free system, which was first proposed in the President's tax reform proposal.

Explanation of Provision

The Act requires a report from the IRS setting forth:

(1) the identification of classes of individuals who would be permitted to use a return-free system;

(2) how such a system would be phased in;

(3) what additional resources the IRS would need to carry out such a system; and

(4) the types of changes to the Internal Revenue Code that would inhibit or enhance the use of such a system.

The report is to be submitted within 6 months of the date of enactment to the Senate Committee on Finance and the House Committee on Ways and Means.

In addition, the IRS is to consider conducting an in-house feasibility test using previously filed information returns and individual income tax returns to test the practicality of the proposed system.

A number of provisions of this Act provide that the Secretary of the Treasury or his delegate is to prescribe regulations. Notwithstanding any of these references, the Secretary may, prior to prescribing these regulations, issue guidance for taxpayers with respect to the provisions of this Act by issuing Revenue Procedures, Revenue Rulings, forms and instructions to forms, announcements, or other publications or releases.

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[70] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1345; H.Rep. 99-426, pp. 859-860; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 563; S.Rep. 99-313, pp. 217-218; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 821 (Conference Report).

Effective Date

The report is due 6 months after the date of enactment.

TITLE XVI—EXEMPT AND NONPROFIT ORGANIZATIONS

A. Exchanges and Rentals of Donor or Member Lists of Certain Tax-Exempt Organizations; Distribution of Low Cost Articles by Charities (Sec. 1601 of the Act and sec. 513 of the Code) [1]

Prior Law

General rules

While generally exempt from Federal income tax, charitable, educational, religious, and certain other organizations described in Code section 501(a) are subject to tax on any unrelated trade or business income (secs. 511-514). Under prior and present law, the tax applies to gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both subject to certain modifications.

An unrelated trade or business is defined as any trade or business of a tax-exempt organization the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the charitable, educational, religious, or other nonprofit purpose and function constituting the basis for its exemption (sec. 513(a)).

Revenues from mailing lists

The U.S. Court of Claims held in 1981 that income received by the Disabled American Veterans from other exempt organizations and commercial businesses for the use of its mailing lists constituted unrelated business taxable income, and did not constitute "royalties" expressly exempted from the tax under section 512(b)(2) (*Disabled American Veterans* v. *U.S.*, 650 F.2d 1178 (1981)). The court found that the DAV, in renting its donor lists, operated in a competitive, commercial manner with respect to taxable firms in the direct mail industry; that these rental activities were regularly carried on; and that the rental activities were not substantially related to accomplishment of exempt purposes (apart from the organization's need for or use of funds derived from renting the mailing lists).

Distribution of low cost articles

Treasury regulations provide that the unrelated business income tax does not apply to income from an activity that does not possess the characteristics of a trade or business (within the meaning of sec. 162). For example, the regulations state that the tax does not apply where an organization "sends out low cost items incidental to the solicitation of charitable contributions" (Reg. sec. 1.513-1(b)). The regulations do not define the term "low cost."

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1404; H.Rep. 99-426, pp. 866-68; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1702; S.Rep. 99-313, pp. 884-85; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 822-23 (Conference Report).

Reasons for Change

The Congress concluded that the unrelated trade or business income tax should not be imposed on income from exchanges or rentals of donor or member lists among tax-exempt organizations eligible to receive charitable contributions, and that it is appropriate to specify the circumstances under which certain distributions of low cost articles incidental to soliciting charitable contributions are not treated as unrelated trade or business activities.

Explanation of Provisions

Revenues from mailing lists

The Act provides that, in the case of any organization exempt from tax under section 501 that is eligible to receive tax-deductible charitable contributions under section 170(c)(2) or section 170(c)(3), the term unrelated trade or business does not include any trade or business of such organization that consists of exchanging names and addresses of donors to (or members of) such organization with another such tax-exempt organization, or of renting donor (or member) names and addresses to another such tax-exempt organization. No inference is intended as to whether or not revenues from mailing list activities other than those described in the provision, or from mailing list activities described in the provision but occurring prior to the effective date, constitute unrelated business income.

Distribution of low cost articles

The Act provides that, in the case of any organization exempt from tax under section 501 that is eligible to receive tax-deductible charitable contributions under section 170(c)(2) or section 170(c)(3), the term unrelated trade or business does not include activities of such organization relating to the distribution of low cost articles incidental to the solicitation of charitable contributions.

For this purpose, an article is treated as low cost if it has a cost not in excess of $5 to the organization that distributes such item (or on whose behalf such item is distributed). Beginning in 1988, this dollar limitation is adjusted for inflation as provided in the Act. If more than one item is distributed by or on behalf of an organization to a single distributee in any calendar year, the aggregate of the items so distributed in the year to such distributee is treated as one article for purposes of the dollar limitation.

A distribution of low cost articles qualifies under the Act as incidental to soliciting charitable contributions only if—

(1) the distribution is not made at the request of the distributee;

(2) the distribution is made without the express consent of the distributee; and

(3) the articles distributed are accompanied both by a request for a charitable contribution (as defined in sec. 170(c)) to such organization, and also by a statement that the distributee may retain the low cost article regardless of whether the distributee makes a charitable contribution to such organization.

Effective Date

These provisions apply to exchanges and rentals of mailing lists and distributions of low cost articles occurring after the date of the enactment of the Act (October 22, 1986).

Revenue Effect

These provisions are estimated to reduce fiscal year budget receipts by $4 million in 1987, $8 million in 1988, $8 million in 1989, $9 million in 1990, and $11 million in 1991.

B. Expansion of UBIT Exception for Certain Trade Show Income (Sec. 1602 of the Act and sec. 513 of the Code) [2]

Prior Law

Under prior and present law, charitable and other tax-exempt organizations are subject to a tax on income from an unrelated trade or business, i.e., a business the conduct of which is not substantially related to the exempt functions of the organization (secs. 511-514).

An exception from the tax is provided for income derived by trade associations (sec. 501(c)(6)), or by labor, agricultural, or horticultural organizations (sec. 501(c)(5)), from qualified trade show and convention activities at which members of the sponsoring organization sell products or services (sec. 513(d)).

Reasons for Change

The Congress concluded that it was appropriate to expand the section 513(d) exception for trade show income from the unrelated business income tax.

Explanation of Provision

The Act expands the section 513(d) exception from the unrelated business income tax to cover (1) qualified trade shows or conventions at which suppliers to the sponsoring organization's members sell products or services related to the exempt activities of the organization, and (2) qualified trade show and convention activities of charitable organizations (sec. 501(c)(3)) and social welfare organizations (sec. 501(c)(4)).

Effective Date

The provision is effective for qualified trade show or convention activities conducted in taxable years beginning after the date of enactment (October 22, 1986).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $4 million in 1987, $8 million in 1988, $12 million in 1989, $16 million in 1990, and $22 million in 1991.

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[2] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 8078-79 (June 20, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 823 (Conference Report).

C. Tax-Exempt Status for Certain Title-Holding Companies (Sec. 1603 of the Act and new sec. 501(c)(25) of the Code)[3]

Prior Law

In general

Under prior and present law, a corporation that is organized for the exclusive purpose of holding title to property, collecting income therefrom, and distributing the income (less expenses) to a tax-exempt organization may itself be exempt from Federal income tax (sec. 501(c)(2)). The Internal Revenue Service has taken the position, in a General Counsel Memorandum (G.C.M. 37351, December 20, 1977), that in order to qualify for tax-exempt status as an organization described in section 501(c)(2), a title-holding corporation may distribute income only to one or more related tax-exempt organizations.

A corporation described in section 501(c)(2) is not tax-exempt, under prior and present law, if it has unrelated business taxable income other than income classified as such solely pursuant to sections 512(a)(3)(C), 512(b)(3)(B)(ii) or (13), or 514 (Treas. Reg. sec. 1.501(c)(2)-1(a)).

Unrelated business income tax

Under prior and present law, any income of an exempt organization from debt-financed property generally is subject to the unrelated business income tax (sec. 514). However, under an exception, certain educational institutions and pension plans generally are not subject to the unrelated business income tax on income from certain debt-financed real property (sec. 514(c)(9)), subject to specified limitations (including such limitations as are applicable to pass-through entities pursuant to sec. 514(c)(9)(D)).

Reasons for Change

The Congress concluded that smaller, unrelated tax-exempt organizations should be able to pool investment funds for purposes of investing in real property through a title-holding company, subject to certain requirements and limitations, with generally the same tax treatment as is available to a larger tax-exempt organization having a title-holding subsidiary that is tax-exempt as an organization described in section 501(c)(2).

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[3] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1706; S.Rep. 99-313, pp. 885-86; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 824 (Conference Report).

Explanation of Provision

In general

The Act adds a new category of organizations that are generally exempt from Federal income tax (new Code sec. 501(c)(25)), consisting of certain corporations or trusts that are organized for the exclusive purposes of acquiring and holding title to real property, collecting income from such property, and remitting the income therefrom (less expenses) to one or more specified categories of tax-exempt organizations that are shareholders of the corporation or beneficiaries of the trust. In addition to satisfying this requirement, an organization is described in section 501(c)(25) only if it has no more than 35 shareholders or beneficiaries and has only one class of stock or beneficial interest.

In order to qualify for exemption under the new category, the corporation or trust also must permit its shareholders or beneficiaries (1) to dismiss, after reasonable notice, the corporation's or trust's investment adviser by majority vote of the shareholders or beneficiaries; and (2) to terminate their interest by (a) selling or exchanging their stock or beneficial interest (subject to Federal or State securities law) to any other eligible organization, as long as such sale or exchange would not increase the total number of shareholders or beneficiaries to more than 35, or (b) redeeming their stock or beneficial interest after providing 90 days' notice to the corporation or trust.

Under the Act, the categories of tax-exempt organizations eligible to hold interests in a section 501(c)(25) title-holding company are (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a governmental pension plan (sec. 414(d)); (3) the United States, a State or political subdivision, or governmental agencies or instrumentalities; (4) tax-exempt charitable, educational, religious, or other organizations described in section 501(c)(3); and (5) other title-holding companies described in section 501(c)(25).

The Act does not amend prior law with respect to title-holding corporations (described in sec. 501(c)(2)) holding title to property for one or more related tax-exempt organizations.

Unrelated business income tax

The Act extends the exception from the unrelated business income tax under the debt-financed property rules for certain real property (sec. 514(c)(9)) to organizations described in new section 501(c)(25). As under prior and present law, this exception is subject to the limitations contained in section 514(c)(9)(B), including the limitations applicable to pass-through entities (sec. 514(c)(9)(D)).

Effective Date

The provision applies for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $7 million in 1987, $18 million in 1988, $33 million in 1989, $56 million in 1990, and $82 million in 1991.

D. Exception to Membership Organization Deduction Rules (Sec. 1604 of the Act and sec. 277 of the Code)[4]

Prior Law

Under prior and present law, a membership organization generally may deduct expenses relating to the furnishing of goods or services to members only from income derived from members or from transactions with members (Code sec. 277). This rule does not apply to certain financial institutions, insurance companies, securities or commodities exchanges, or certain other organizations.

Reasons for Change

The Congress concluded that it was appropriate to provide an additional exception to the section 277 deduction limitation rule for membership organizations that are engaged primarily in the gathering and distribution of news to their members for publication.

Explanation of Provision

The Act provides an additional exception to the section 277 deduction limitation rule for membership organizations that are engaged primarily in the gathering and distribution of news to their members for publication.

Effective Date

The provision is effective for taxable years beginning after the date of enactment (October 22, 1986).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

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[4] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 7793-94 (June 18, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 826 (Conference Report).

E. Tax-Exempt Status for a Technology Transfer Organization (Sec. 1605 of the Act and sec. 501(c)(3) of the Code) [5]

Prior Law

In November 1985, the U.S. Tax Court denied tax-exempt status under section 501(c)(3) to the Washington Research Foundation, a nonprofit organization formed to assist the transfer of technology from universities and tax-exempt research institutions to the private sector. The Tax Court held that the organization was not operated exclusively for charitable purposes because its major activity of providing patenting and licensing services was commercial in nature.[6]

Reasons for Change

The Congress concluded that it was appropriate to provide tax-exempt status to the Washington Research Foundation.

Explanation of Provision

The Act provides that an organization incorporated on July 20, 1981, that transfers technology from universities and scientific research organizations (described in secs. 41(e)(6)(A) or (B)) to the private sector is treated as organized and operated exclusively for charitable purposes if it meets certain requirements specified in the Act. The intended beneficiary of this provision is the Washington Research Foundation. No inference is intended as to whether such technology transfer or related purposes or functions of any other organization constitute purposes or functions described in Code sections 501(c)(3) or 170(c).

Effective Date

The provision is effective on the date of enactment (October 22, 1986).

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

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[5] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 8072 (June 20, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 826-27 (Conference Report).

[6] *Washington Research Foundation* v. *Comm'r*, 50 CCH TCM 1457 (1985).

F. Definition of Disqualified Person for Private Foundation Rule Purposes (Sec. 1606 of the Act and sec. 4946(c)(5) of the Code) [7]

Prior Law

Under prior and present law, any direct or indirect agreement by a private foundation to make any payment to a government official generally constitutes a taxable act of self-dealing (Code sec. 4941). The term government official included, under prior law, an individual holding elective or appointive public office in the government of a State, U.S. possession, political subdivision or area of the foregoing, or the District of Columbia, only if such official received gross compensation at an annual rate of $15,000 or more (sec. 4946(c)(5)).

Reasons for Change

The Congress concluded that it was appropriate to increase the compensation floor in determining which State or local officials are treated as government officials for purposes of certain private foundation rules.

Explanation of Provision

Under the Act, an individual holding elective or appointive public office in the government of a State, U.S. possession, political subdivision or area of the foregoing, or the District of Columbia constitutes a government official for purposes of the section 4941 self-dealing rules only if such official receives gross compensation at an annual rate of $20,000 or more.

Effective Date

The provision applies with respect to compensation received after December 31, 1985.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

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[7] For legislative background of the provision, see: H.Rep. 99-841, Vol. I (September 18, 1986), sec. 1606 (Conference Report).

TITLE XVII—MISCELLANEOUS PROVISIONS

A. Targeted Jobs Tax Credit (Sec. 1701 of the Act and sec. 51 of the Code) [1]

Prior Law

Background

The targeted jobs tax credit (Code sec. 51) was enacted in the Revenue Act of 1978 to replace an expiring credit for increased employment. As originally enacted, the targeted jobs credit was scheduled to terminate after 1981.

The availability of the credit was successively extended by the Economic Recovery Tax Act of 1981 (ERTA) for one year, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) for two years, and the Deficit Reduction Act of 1984 (the 1984 Act) for one year. Under prior law, the credit did not apply with respect to individuals who began work for the employer after December 31, 1985. For individuals who began work before 1986, the credit was available for wages paid during the first 24 months of employment.

ERTA, TEFRA, and the 1984 Act also modified the targeted group definitions and made several technical and administrative changes in the credit provisions. In addition, TEFRA authorized appropriations for the expenses of administering the system for certifying targeted group membership and of providing publicity to employers regarding the targeted jobs credit. The 1984 Act extended the authorization for appropriations for administrative and publicity expenses through fiscal year 1985.

Targeted jobs credit rules

The targeted jobs tax credit is available on an elective basis for hiring individuals from one or more of nine targeted groups. The targeted groups are (1) vocational rehabilitation referrals; (2) economically disadvantaged youths (ages 18-24); (3) economically disadvantaged Vietnam-era veterans; (4) SSI recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students (ages 16-19); (7) economically disadvantaged former convicts; (8) AFDC recipients and WIN registrants; and (9) economically disadvantaged summer youth employees (ages 16-17).

Under prior law, the credit generally equalled 50 percent of the first $6,000 of qualified first-year wages plus 25 percent of the first $6,000 of qualified second-year wages paid to a member of a targeted group. Thus, the maximum credit was $3,000 per individual in the first year of employment and $1,500 per individual in the second year of employment. In the case of economically disadvantaged summer youth employees, the credit equals 85 percent of up to $3,000 of wages, for a maximum credit of $2,550. The employer's deduction for wages is reduced by the amount of the credit.

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[1] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 282; H.Rep. 99-426, pp. 228-29; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1708; S.Rep. 99-313, pp. 880-82; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 828-29 (Conference Report).

Reasons for Change

While evidence regarding the relative efficiency of the targeted jobs tax credit as an incentive for hiring disadvantaged individuals remained incomplete, the Congress concluded that experience with the credit since its enactment in 1978 had been sufficiently promising to warrant a further extension of the credit. This extension is intended to provide the Congress and the Treasury Department an opportunity to gather more information on the operation of the credit, so that its effectiveness as a hiring incentive can be more fully assessed.

Although the Congress has limited the credit in certain respects, the resulting reduction in tax benefits to some employers will be wholly or partially offset in many cases by the tax savings arising from the Act's general reduction in tax rates.

Explanation of Provisions

Extension of credit

The Act extends the targeted jobs credit for three additional years, with modifications. Under the Act, the modified credit is available for wages paid to targeted-group individuals who begin work for an employer after December 31, 1985 and before January 1, 1989.

Modification of credit

The Act limits the extended credit in three respects. First, the 25-percent credit for qualified wages paid in the second year of a targeted-group individual's employment is repealed. Second, the 50-percent credit for qualified first-year wages generally is reduced to a 40-percent credit. Thus, the Act generally reduces the maximum credit per employee from $4,500 (50 percent of $6,000 plus 25 percent of $6,000) to $2,400 (40 percent of $6,000). However, the Act does not reduce the credit allowed for wages of economically disadvantaged summer youth employees (85 percent of up to $3,000 of qualified first-year wages).

Third, under the Act, no wages paid to a targeted-group member are taken into account for credit purposes unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees).

The Act does not otherwise modify the statutory requirements for obtaining the credit during the three-year extension period applicable to individuals beginning work on or after January 1, 1986. For example, throughout that period, an employed individual cannot qualify as a member of a targeted group unless the employer received or requested in writing on or before the day on which the individual began work a certification of targeted-group membership from the appropriate State employment security agency.[2]

Authorization for appropriations

The Act extends the authorization for appropriations for administrative and publicity expenses to fiscal years 1986 through 1988. To the extent feasible, the Internal Revenue Service and the Department of Labor should inform employers (e.g., through press releases or announcements) of the extension of the credit.

Effective Date

The provisions apply with respect to targeted-group individuals who begin work for the employer after December 31, 1985 and before January 1, 1989. Under the Act, the credit does not apply with respect to individuals who begin work for the employer after December 31, 1988.

Revenue Effect

The provisions are estimated to reduce fiscal year budget receipts by $152 million in 1987, $231 million in 1988, $228 million in 1989, $129 million in 1990, and $60 million in 1991.

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[2] If the employed individual received a written preliminary determination of targeted-group membership by the date on which the individual began work, the employer has until the fifth day of such individual's employment to receive or request certification.

B. Collection of Diesel Fuel and Gasoline Excise Taxes

1. Diesel fuel tax (sec. 1702 of the Act and sec. 4041(n) of the Code)[3]

Prior Law

An excise tax of 15.1 cents per gallon is imposed on the sale of diesel fuel for use in a diesel-powered highway vehicle (Code sec. 4041(a)(1)). Revenues equivalent to this tax are deposited in the Highway Trust Fund (15 cents per gallon) and the Leaking Underground Storage Tank Trust Fund (0.1 cents per gallon). Under prior law, the tax was imposed and collected at the retail level.

Reasons for Change

Since there are many more outlets for diesel fuel retail sales than diesel fuel wholesalers, the Congress concluded that allowing the tax to be collected by the wholesaler (or producer for direct sales) upon the sale to the retailer will reduce the tax administrative burden on the numerous retail diesel fuel outlets and also reduce the tax collection and enforcement costs to the Treasury Department.

Explanation of Provision

The Act provides that, under regulations prescribed by the Treasury Department, the excise tax on diesel fuel for highway vehicles may be imposed on the sale to the retailer by the wholesaler (jobber) or by the producer where the sale is direct to the retailer.[4] This applies only in the case of a sale of diesel fuel to a "qualified retailer," defined as any retailer who (1) elects to have this provision apply with respect to all sales of diesel fuel to such retailer and (2) agrees to provide a written notice to the person selling diesel fuel to such retailer that such an election has been made concerning application of the diesel fuel tax.

A retailer who is required to notify the seller of diesel fuel but fails to do so is liable for payment of the tax for any period during which the failure continues. In addition, unless such failure is shown to be due to reasonable cause and not to willful neglect, the retailer must pay a penalty with respect to each sale of diesel fuel to the retailer equal to five percent of the excise tax amount involved.

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[3] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1351; H.Rep. 99-426, p. 861; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 830-831 (Conference Report).

[4] An additional tax of 0.1 cents per gallon was imposed on diesel fuel by P.L. 99-499. The Congress intended that this additional tax is to be collected by wholesalers in the same manner as the general diesel tax of 15.0 cents per gallon. A technical amendment may be necessary to reflect this intent.

Effective Date

The provision applies to sales of diesel fuel after the first calendar quarter beginning more than 60 days after the date of enactment of the Act (October 22, 1986).

Revenue Effect

This provision is estimated to increase net fiscal year budget receipts by $5 million in 1987, and by negligible amounts each year thereafter.

2. Gasoline tax (sec. 1703 of the Act and secs. 4081-4083 and 6421 of the Code)[5]

Prior Law

An excise tax of 9.1 cents per gallon is imposed on the sale of gasoline by producers (Code sec. 4081). Under prior law, the term producer was defined to include wholesale distributors and other intermediaries (other than retailers) in the chain of distribution for gasoline who registered with the Treasury Department. Revenues equivalent to this tax are deposited in the Highway Trust Fund (nine cents per gallon) and the Leaking Underground Storage Tank Trust Fund (0.1 cents per gallon).

Reasons for Change

The Congress was concerned about reports of widespread evasion of the gasoline tax by persons with access to Treasury registration numbers for gasoline distributors, who used these registration numbers to purchase gasoline without payment of tax and resold it as if tax had been paid (but who remitted no tax). The Congress determined that this problem could best be eliminated by restricting the number of persons who are qualified to purchase gasoline without payment of tax.

Explanation of Provision

Under the Act, the gasoline tax is imposed on removal from the refinery (including customs custody for imported gasoline) or sale (if earlier) of gasoline, gasoline blend stocks, and products commonly used as additives in gasoline. An exception is provided permitting bulk transfers of gasoline, gasoline blend stocks, or additives to registered and bonded terminals without payment of tax. In such cases, terminal operators are liable for collection and payment of the tax upon removal of the gasoline, gasoline blend stocks, or additives from the terminal.

Registered gasohol blenders are permitted to purchase gasoline at a 3.05-cents-per-gallon tax[6] if blending occurs at the terminal. In all other cases, gasohol blenders (like other purchasers) must purchase gasoline and gasoline blend stocks tax-paid. Blenders (other than registered gasohol blenders that blend at the terminal) are taxable on the use or sale of blended gasoline. However, they may claim a credit for any tax paid on purchases of gasoline, blendstocks, or additives to the extent that excess tax has been paid. Purchasers also may obtain a refund upon establishing that the ultimate use of a product on which tax was paid was not as a taxable fuel.

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[5] For legislative background of the provision, see H.Rep. 99-841, Vol. II (September 18, 1986), pp. 830-831 (Conference Report).

[6] The Congress intended that this rate be 3.05 cents per gallon rather than three cents per gallon. A technical amendment may be necessary to reflect this intent.

A special, accelerated refund procedure is provided for gasohol blenders who buy tax-paid. Under this procedure, if the Treasury Department has not paid a claim within 20 days of the date of filing, the claim is to be paid with interest from such date.

The Congress intended that the Treasury Department is to prescribe regulations defining the terms gasoline blend stocks and products commonly used as additives in gasoline. These regulations also may require that all persons who must register post bond. In addition, the Treasury Department may register industrial users of gasoline blend stocks or additives as terminal operators, permitting them to purchase such products in bulk form tax-free.

Further, the Treasury Department is directed to study the incidence of evasion of the gasoline tax and to report thereon to the Congress.

Effective Date

This provision applies to gasoline removed from a refinery or pipeline terminal after December 31, 1987. A floor stocks tax, equal to 9.1 cents[7] per gallon, is imposed on all gasoline held for resale beyond the new point of tax on January 1, 1988.

Revenue Effect

This provision is estimated to increase net fiscal year budget receipts by $317 million in 1988, $193 million in 1989, $195 million in 1990, and $198 million in 1991.

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[7] A technical amendment may be necessary to reflect the intent of the Congress that the floor stocks rate be 9.1 cents per gallon.

C. Social Security and FUTA Provisions

1. Re-election of social security coverage by certain ministers (sec. 1704 of the Act and sec. 1402 of the Code)[8]

Prior Law

The Federal Insurance Contributions Act (FICA) imposes separate payroll taxes on employers and employees equal to a percentage of wages paid as remuneration for employment. For self-employed individuals, a similar tax is imposed on self-employment income under the Self-Employment Contributions Act (SECA). These taxes are used to fund social security programs.

As a general rule, ministers of a church, members of religious orders, and Christian Science practitioners ("ministers") are treated as self-employed individuals for purposes of SECA taxes, even if otherwise they would be classified as employees (Code secs. 1402(c), 3121(b)(8)). However, a minister who is conscientiously, or because of religious principles, opposed to participation in a public insurance system generally may elect to be exempt from social security coverage and SECA taxes by filing with the Internal Revenue Service an application for such exemption within two years of beginning the ministry (sec. 1402(e)). Under prior law, such an election out of social security coverage was irrevocable.

Reasons for Change

The Congress concluded that ministers who had elected out of social security coverage on religious or conscientious grounds should be allowed a limited period to elect back irrevocably into social security coverage. Also, the Congress believed that the procedures for electing out should be modified to assure that the minister is aware of the grounds for exemption and is seeking exemption on such grounds.

Explanation of Provisions

Elections back

The Act provides a limited period (generally, up to April 15, 1988) during which a minister who previously had elected out of social security coverage may make an irrevocable election back into social security coverage. An electing minister becomes subject to SECA tax, and his or her post-election earnings are credited for social security benefit purposes, as specified in the Act.

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[8] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 7795, 7802-03 (June 18, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 831-32 (Conference Report).

Elections out

Under the Act, Treasury regulations are to provide that exemption applications filed with the Internal Revenue Service (after 1986) are to include information showing that the applicant has informed the ordaining, commissioning, or licensing body of the church or order of his or her religious or conscientious opposition to social security coverage, in conformity with the revised exemption procedure.

The regulations may provide procedures under which, pursuant to agreement between the Secretary of the Treasury and the Secretary of Health and Human Services, HHS has the responsibility of communicating with the applicant in order to make the separate verification required under the Act as a prerequisite for approving the exemption application. The Act does not require that the subsequent verification be in-person or by telephone communication, but the verification procedure must be effective to establish that the applicant is aware of the grounds for exemption from the social security system and has sought an irrevocable exemption on such grounds. Under these procedures, the disclosure of information to HHS by the Internal Revenue Service concerning a ministerial exemption application for such verification purposes is authorized by Code section 6103(l)(1).

Effective Date

The provision allowing an irrevocable election back into social security coverage applies (to the extent specified in the provision) in taxable years ending on or after the date of the enactment of the Act (October 22, 1986) and with respect to monthly insurance benefits payable under title II of the Social Security Act on the basis of the wages and self-employment income for months in or after the calendar year in which the individual's application for revocation is effective (and lump-sum death payments payable under such title on the basis of such wages and self-employment income in the case of deaths occurring in or after such calendar year).

The provision revising the exemption application procedure is effective for applications filed after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year employment tax receipts by $1 million in 1987, $5 million in 1988, and $6 million annually in 1989-91.

2. Application of FUTA tax to certain Indian tribal governments (sec. 1705 of the Act and sec. 3306 of the Code)[9]

Prior Law

Generally, Indian tribal governments are subject to Federal unemployment tax (FUTA) on the same basis as private employers.

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[9] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 7794-95 (June 18, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 833-34 (Conference Report).

Under prior law, no exception was provided if unemployment compensation coverage was denied by the State in which the employer conducted business. Certain Indian tribal governments have been denied unemployment compensation coverage by the State of Colorado and are not required to pay State unemployment compensation taxes.

Reasons for Change

The Congress concluded that it was appropriate to provide an exemption from FUTA tax for certain Indian tribal governments the service for which was not covered by a State unemployment compensation program.

Explanation of Provision

The Act provides an exemption from FUTA tax for Indian tribal governments the service for which was not covered by a State unemployment compensation program on June 11, 1986, with respect to service in the employ of such tribal government during a period in which the tribal government is not covered by a State unemployment compensation program.

Effective Date

This provision is effective for services performed before January 1, 1988, including services performed prior to the date of enactment (but does not authorize a refund of any previously paid FUTA tax). It is anticipated that the State of Colorado and the affected Indian tribal governments will work out an unemployment compensation coverage agreement prior to January 1, 1988 similar to such agreements currently in effect in other States.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $1 million annually.

3. Treatment of certain technical personnel (sec. 1706 of the Act and sec. 530 of the Revenue Act of 1978)[10]

Prior Law

Background of 1978 Act

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test. Under this test, an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished (Treas. Reg. sec. 31.3401(c)-(1)(b)).

If an employer-employee relationship exists, the service-recipient is subject to social security taxes under the Federal Insurance Contribution Act (FICA) and unemployment taxes under the Federal Unemployment Tax Act (FUTA), and is required to withhold and pay over FICA and income taxes imposed on the worker. On the other hand, if there is no employer-employee relationship, the service-recipient is not subject to employment taxes; the worker pays self-employment tax in lieu of FICA tax and makes quarterly estimated income tax payments. Historically, the total FICA tax rates imposed on an employer and employee have been significantly higher than the rate of self-employment tax on the same amount of wages.[11]

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[10] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 8088-89 (June 20, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 834-35 (Conference Report).

With increased enforcement of the employment tax laws beginning in the late 1960's, controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as independent contractors rather than as employees. In some instances when the IRS prevailed in reclassifying workers as employees under the common-law test, the employing business became liable for substantial portions of its employees' FICA and income tax liabilities (that the employer had failed to withhold and pay over), although the employees might have fully paid their liabilities for self-employment and income taxes. This double payment of essentially the same tax liabilities was possible because of the administrative difficulties of complying with the requirements imposed by the IRS on employers and employees under the then tax law to avoid such duplicate liabilities.

Revenue Act of 1978

In response to this problem, the Congress enacted section 530 of the Revenue Act of 1978 (P.L. 95-600). That provision, which originally was intended to be a temporary measure pending further legislation, generally allowed a taxpayer to treat a worker as not being an employee—regardless of the individual's actual status under the common-law test—unless the taxpayer had no reasonable basis for such treatment. Under section 530, a reasonable basis was considered to exist for this purpose if the taxpayer reasonably relied on certain factors, such as a longstanding industry practice or the past failure of the IRS to raise such an employment tax issue on audit.

This relief under section 530 was made available with respect to an individual only if certain additional requirements are satisfied. One of these requirements was that the taxpayer (or a predecessor) must not have treated any individual holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977.

Subsequent legislation

The relief granted by section 530, initially scheduled to terminate at the end of 1979, subsequently was extended through the end of 1980 by P.L. 96-167 and through June 30, 1982, by P.L. 96-541. In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (P.L. 97-248), the Congress extended the section 530 relief indefinitely, pending enactment of further statutory classification rules.

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[11] This difference in tax rates is being phased out, pursuant to the Social Security Amendments of 1983 (P.L. 98-21). In years beginning after 1989, the difference will be substantially eliminated.

In addition to providing classification rules for qualified real estate agents and direct sellers, TEFRA enacted a statutory mechanism to prevent the imposition of burdensome tax liabilities on employers when individuals treated as independent contractors were reclassified as employees. In general, the new provision made employers liable only for a portion of the worker's FICA and income tax liabilities that had not been withheld, determined by calculating the employer liability after reduction for an average amount paid by employees (Code sec. 3509).

Reasons for Change

In TEFRA, the Congress resolved one of the major problems that had led to enactment of section 530 of the Revenue Act of 1978, by providing a statutory mechanism that imposed a more appropriate employment tax liability on employers if their workers were reclassified as employees. However, the 1982 legislation did not address the problem of competitive unfairness created by section 530, which originally had been intended to serve only as an interim relief measure pending enactment of permanent classification rules.

In particular, the requirement for obtaining relief under section 530—that all similar individuals have been treated as nonemployees for all periods after 1977—established a competitive advantage for taxpayers that consistently took the position that their workers were independent contractors. These taxpayers were not subject to employer FICA and FUTA taxes and did not have to withhold FICA and income taxes from their workers. By contrast, competitors of such taxpayers who at any time after 1977 acknowledged that their workers were employees were denied the tax benefits of section 530 relief.

In addition to the inequities created by the application of section 530 with respect to employment taxes, additional inequities have arisen based on claimed reliance on the relief provisions of section 530 for income tax purposes. Although section 530 provides relief only with respect to the employment tax liability of the service-recipient, it apparently has been used to justify claims of independent contractor status for income tax purposes, both by the "employer" and by individuals whose "employer" claims relief under section 530. An employer might wish to treat workers as independent contractors for income tax purposes to attempt to avoid otherwise required coverage of such individuals under the employer's retirement and employee benefit plans. Such status for income tax purposes also conveys certain tax advantages with respect to the workers, such as the ability of an independent contractor to maintain a Keogh plan and to take certain business deductions unavailable to employees.

Moreover, IRS studies have indicated that compliance is a much greater problem in the case of independent contractors, both through underreporting of income and through inappropriately claiming deductions. Thus, workers who are properly characterized as employees under the common-law test but who improperly rely on section 530 to assert independent contractor status for income tax purposes may be claiming tax benefits unavailable to the much larger number of workers who are treated as employees pursuant to the common-law test.

The Congress was informed that many employers in the technical services industry that did not qualify for relief under section 530 nonetheless had claimed that their workers were independent contractors, despite the fact that such workers would be classified as employees under the common-law test. It is further contended that some of these employers were relying on erroneous interpretations of section 530, while others simply perceived that the IRS would not aggressively enforce employment tax issues. Thus, the Congress concluded that taxpayer interpretations of section 530 had contributed to substantial noncompliance favoring taxpayers who were willing to take aggressive positions on their tax returns.

Moreover, the Congress understood that some taxpayers in the technical services area had interpreted narrowly the statutory requirement that section 530 applies only with respect to a worker if the taxpayer has treated all workers holding "substantially similar" positions as independent contractors at all times after 1977. These taxpayers took the position that, although they treat certain technical services personnel as employees and other technical services personnel as independent contractors, the section 530 requirement relating to consistent treatment of similar workers was satisfied. In such cases, the taxpayer might rely on minor differences in the manner in which services are provided by the workers treated as employees and by those treated as independent contractors to justify claiming section 530 relief.

In light of these factors, some employers in the technical services industry that have not taken the aggressive positions described above urged the Congress both to repeal section 530 with respect to technical services personnel and also to provide that technical services personnel must be treated as employees for all tax purposes without regard to the common-law test. The Congress concluded that the latter change would be inappropriate, as it would single out technical services personnel for such treatment. However, the Congress concluded that removing the protection of section 530 with respect to these personnel would not unfairly subject them to rules not applicable to other workers. On the contrary, this approach would subject these personnel to the same common-law test applicable to the vast majority of workers. While similar situations also may exist in other industries, the Congress concluded that it should limit the provision in the Act to the technical services area, because taxpayer complaints about competitive disadvantages of section 530 had been concentrated in that area.

Explanation of Provision

The Act provides that section 530 of the Revenue Act of 1978 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

Under this exception to section 530, individuals who are retained by firms and who provide the technical services described above are to be classified, for income and employment tax purposes, as employees or as independent contractors under the common-law test without regard to section 530. Further, by virtue of this exception to section 530, the prohibition in section 530 against issuance of Treasury regulations or revenue rulings concerning employment tax status does not apply with respect to the employment tax status of such individuals.

The provision applies whether the services of such individuals are provided by the firm to only one client during the year or to more than one client, and whether or not such individuals have been designated or treated by the technical services firm as independent contractors, sole proprietors, partners, or employees of a personal service corporation controlled by such individual. Thus, the effect of the provision cannot be avoided by claims that such technical services personnel are employees of personal service corporations controlled by such personnel. For example, an engineer retained by a technical services firm to provide services to a manufacturer cannot avoid the effect of this provision by organizing a corporation that he or she controls and then claiming to provide services as an employee of that corporation.

This provision does not affect the application of Code section 414(n), relating to employee leasing, or section 414(o), relating to the prevention of avoidance of certain employee benefit requirements, to technical services personnel in circumstances where such provisions apply. Also, the provision does not apply with respect to individuals who are classified, under the generally applicable common-law test, as employees of a business that is a client of the technical services firm.

Effective Date

The provision applies to remuneration paid and services rendered after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $7 million in 1987, $11 million in 1988, $12 million in 1989, $14 million in 1990, and $16 million in 1991.

D. Other Provisions

1. Exclusion from gross income for certain foster care payments (sec. 1707 of the Act and sec. 131 of the Code)[12]

Prior Law

Prior law provided that a foster parent generally may exclude from gross income amounts paid as reimbursements for the expenses of caring for a foster child under the age of 19 in the foster parent's home (Code sec. 131). To qualify for exclusion, the payments must be made by a State or political subdivision or by a State-licensed, tax-exempt child-placement agency. Also, the foster child must have been placed in the home by an agency of a State or political subdivision, or by a State-licensed, tax-exempt child-placement agency. The exclusion also applies to certain difficulty of care payments.

To implement the exclusion for reimbursements of foster care expenses, the Internal Revenue Service required foster parents to account for the expenses incurred for each foster child in their care. This accounting was required because, under prior law, any excess of foster care payments over actual expenses in the year was includible in gross income.

Reasons for Change

The Congress concluded that the current level of foster care payments closely approximates (or perhaps understates) the costs incurred in the care of foster children. Accordingly, the Congress believed that it is unnecessary to require foster parents to maintain detailed records of every expenditure in connection with each foster child as a condition for the exclusion to apply to foster care payments from State agencies or certain State-licensed child-placement agencies. The recordkeeping necessitated by prior law required prorating such expenses as housing and utility costs as well as expenditures for food. The Congress believed that the requirement of such detailed and complex recordkeeping might deter families from accepting foster children or from claiming the full exclusion from income to which they might be entitled.

Also, the Congress believed that it was appropriate to extend the exclusion to certain adult foster care payments.

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[12] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1401; H.Rep. 99-426, pp. 863-864; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 838-839 (Conference Report).

Explanation of Provisions

In general

The Act modifies the prior-law exclusion for certain foster care reimbursements so that the exclusion applies to amounts paid for qualified foster care, rather than amounts paid as reimbursements of qualified foster care expenses. As a result, recordkeeping to establish the extent to which payments reimburse particular foster care expenses is no longer necessary.

Adult foster care

The Act deletes the prior-law limitation that the exclusion applies with respect to foster care only of children under age 19. However, in the case of any foster home in which there is a foster care recipient who has attained age 19, foster care payments (and difficulty of care payments) are not excludable to the extent made for more than five such foster care recipients.

This extension of the exclusion to adult foster care applies only to taxpayers who provide foster care within their own homes to adults who have been placed in their care by an agency of the State or political subdivision thereof specifically designated as responsible for such function. The exclusion does not apply to payments to operators of boarding homes who provide room and board to adults other than adults who have been placed in their care through the actions of a governmental agency responsible for adult foster care.

Effective Date

The provision is effective for taxable years beginning on or after January 1, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $5 million in 1987, $8 million in 1988, $9 million in 1989, $11 million in 1990, and $12 million in 1991.

2. Reinstatement of rules for spouses of Vietnam MIAs (sec. 1708 of the Act and secs. 2(a)(3)(B), 692(b), 6013(f)(1), and 7508(b) of the Code)[13]

Prior Law

In 1976, the Congress provided that four tax relief provisions applied to members of the U.S. Armed Forces listed as missing in action (MIA) in the Vietnam conflict.

The first provision, relating to the definition of a surviving spouse, stated that the date of death of a person in MIA status is the date of determination of death made by the Armed Forces under 37 U.S.C. secs. 555 and 556. The second provision exempted from Federal income tax the income of a member of the Armed Forces determined to have died while in MIA status, for the year in which the determination of death was made under 37 U.S.C. secs. 555 and 556 and any prior year which ends on or after the first day the member served in a combat zone. The third provision provided that the spouse of an individual in MIA status could elect to file a joint return. The fourth provision applied to the spouse of a member in MIA status the rule postponing the performing of certain acts by reason of service in a combat zone, including the filing of returns and the payment of taxes.

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[13] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1402; H.Rep. 99-426, p. 864; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1701; S.Rep. 99-313, pp. 882-883; and H.Rep. 99-841, Vol. II (September 18, 1986), p. 839 (Conference Report).

These relief provisions originally applied through 1978 in the case of Vietnam MIAs. However, for status determinations under 37 U.S.C. secs. 555 and 556 that were not completed, the provisions subsequently were extended through December 31, 1982.

Reasons for Change

The Congress concluded that these relief provisions should be retroactively reinstated with respect to Vietnam MIAs because of the continued need for such provisions.

Explanation of Provision

Under the Act, the four tax relief provisions applicable with respect to Vietnam MIAs (and their spouses) that expired after 1982 are retroactively reinstated and made permanent.

Effective Date

The provision is effective for taxable years beginning after December 31, 1982.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

3. Tax exemption for certain reindeer-related income (sec. 1709 of the Act)[14]

Prior Law

Under the Reindeer Industry Act of 1937 (the 1937 Act),[15] the United States Government purchased all reindeer herds and improvements held by non-Alaskan natives. Since then, this property has been held in trust by the government for Alaskan natives who manage the reindeer herds. The U.S. Court of Appeals for the Ninth Circuit ruled in 1984 that reindeer-related income derived by Alaskan natives from herds is not exempt from Federal taxation.

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[14] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 8053-54 (June 20, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 839 (Conference Report).

[15] Act of September 1, 1937 (50 Stat. 900, ch. 897).

Reasons for Change

The Congress concluded that reindeer-related income derived by Alaskan natives from herds should be exempt from Federal income taxation.

Explanation of Provision

The Act provides that during the period of the trust, income derived directly from the sale of reindeer or reindeer products as provided in the 1937 Act is exempt from Federal income taxation.

Effective Date

This provision applies as if originally included in the related provision of the 1937 Act.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

4. Due dates for certain HHS quality control study and regulations relating to AFDC and Medicaid (sec. 1710 of the Act and sec. 12301 of P.L. 99-272)[16]

Prior Law

Under section 12301 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), the Department of Health and Human Services (HHS) and the National Academy of Sciences (NAS) are required to undertake a study of quality control measures in connection with the administration of the Aid to Families with Dependent Children and Medicaid programs. Under COBRA, HHS and NAS were required to report the results of their study to the Congress within one year of the date of enactment of that statute (April 7, 1986). In addition, HHS was required to publish certain regulations relating to such quality control measures within 18 months of the date of enactment of COBRA.

Reasons for Change

The Congress concluded that the due dates for a quality control study by HHS and NAS relating to AFDC and Medicaid and for certain HHS regulations should be extended.

Explanation of Provision

The Act requires HHS and NAS to report the results of the quality control study required under COBRA within one year after contracting to undertake the study. The date by which HHS is required to publish the specified regulations is six months after the deadline for reporting the results of the quality control study to the Congress.

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[16] For legislative background of the provision, see: Senate floor amendment, 132 Cong. Rec. S 7952 (June 19, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), p. 840 (Conference Report).

Effective Date

The provision is effective on enactment.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts.

5. Adoption assistance program of the Social Security Act (sec. 1711 of the Act and sec. 473 of the Social Security Act)[17]

Prior Law

Section 135 of the Act repeals the prior-law itemized deduction for up to $1,500 of adoption expenses paid or incurred for the legal adoption of a child with special needs (Code sec. 222). Deductible expenses included reasonable and necessary adoption fees, court costs, and attorney fees.

The criteria in the Adoption Assistance Program authorized under Title IV-E of the Social Security Act and used by the States in defining a child with special needs were used in determining whether a taxpayer could claim an adoption expense deduction related to the adoption of a particular child. However, the prior-law deduction, unlike assistance provided under the Title IV-E program, was not limited to adoption of AFDC, AFDC foster care, or SSI disabled or blind children.

Reasons for Change

In view of the Congressional decision to repeal the adoption expense deduction (see explanation in Part I.D.3., above, of sec. 135 of the Act), the Congress agreed to provide Federal matching funds to States to pay for certain adoption expenses related to the legal adoption of a special needs child. The Congress believed that benefits of the Adoption Assistance Program could be more efficiently directed to those who need financial assistance in such adoption cases, whereas the prior-law deduction for adoption expenses gave relatively more benefit to higher income taxpayers and no benefit to nonitemizers.

Explanation of Provision

The Adoption Assistance Program under Title IV-E of the Social Security Act is amended to provide 50-percent Federal matching funds to States to pay for nonrecurring adoption expenses related to the adoption of a special needs child. The expenses for which a State could claim Federal matching funds are those expenses defined as qualified adoption expenses in Code section 222, as in effect prior to its repeal by the Act.

Under the Act, the Congress intended that assistance will be provided under the Title IV-E Adoption Assistance Program to adoptive parents who adopt children with special needs and who would have been eligible to claim an adoption expense deduction under prior tax law. This includes adoptive parents of all special needs children placed according to State and local law and is not limited to those adoptive parents of special needs children who are eligible under the present Title IV-E program, i.e., those who adopt a AFDC, AFDC foster care, or SSI disabled or blind child.

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[17] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 1407; H. Rep. 99-426, pp. 875-876; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 22-23 (Conference Report).

While the Act extends assistance for nonrecurring adoption expenses to adoptive parents of all special needs children, the program of monthly adoption assistance payments will remain limited to those who adopt AFDC, AFDC foster care, or SSI children. To ensure continued assistance to those adoptive parents who adopt children with special needs, and who would have been eligible to claim an adoption expense deduction under prior law, the Congress intended that close working relationships between the public and private adoption agencies should be established.

Under the Act, the State Title IV-E Adoption Assistance agency is to make arrangements with the licensed private adoption agencies in the State whereby adoptive parents can, by way of the private agency, be reimbursed for some or all of the costs which, under prior law, the parents could claim as a qualified adoption expense deduction. In addition to reimbursement of the adoptive parents through the private adoption agencies, States are encouraged to have purchase of service agreements in place so that all or a part of the adoption fees normally charged to the adoptive parents could be paid for on behalf of the adoptive parents directly by the State Title IV-E agency. Those arrangements or agreements would be for the purpose of ensuring that expenses incurred by or on behalf of the adoptive parents be treated the same as if the adoptive activities were provided by the public adoption agency.

The prior-law itemized deduction for certain adoption expenses was subject to a cap of $1,500. The Title IV-E statute also allows a State to establish limits under adoption assistance agreements on the amount of recurring monthly adoption assistance payments to be provided to adoptive parents. This general authority for a State to set limits on the amount of assistance to be provided to adoptive parents will also apply under the Act to nonrecurring adoption expenses. However, the amount of the assistance will not be limited, as is the case for monthly adoption assistance, to the amount that would have been paid for foster care. In other words, as under present adoption assistance agreements, a State may set limits on the amount of the expenses to be financed by the State and the amount may vary among adoptive parents depending on the circumstances of the parents and the child.

Effective Date

The provision amending the adoption assistance program in Title IV-E of the Social Security Act is effective for expenditures made after December 31, 1986.

Revenue Effect

This provision is estimated to increase budget outlays by amounts comparable to the amounts of increased budget receipts resulting from repeal of the prior-law itemized deduction for certain adoption expenses (see explanation in Title I, Part D., 3., above, of sec. 135 of the Act).

APPENDIX: ESTIMATED REVENUE EFFECTS OF THE ACT

Table A-1.—Summary of Estimated Budget Effects of the Act (H.R. 3838), Fiscal Years 1987–1991

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
I. Individual Income Tax Provisions						
Individual	−27,374	−70,736	−71,724	−57,849	−60,376	−288,059
Corporate	891	1,452	1,551	1,736	1,871	7,501
Total	**−26,483**	**−69,284**	**−70,173**	**−56,113**	**−58,505**	**−280,558**
II. Capital Cost Provisions						
Individual	3,216	2,994	4,815	7,693	9,740	28,458
Corporate	14,510	17,187	25,059	30,404	37,928	125,088
Total	**17,726**	**20,181**	**29,874**	**38,097**	**47,668**	**153,546**
III. Capital Gains and Losses						
Individual	(1)	(1)	(1)	(1)	(1)	(1)
Corporate	(1)	(1)	(1)	(1)	(1)	(1)
Total	(1)	(1)	(1)	(1)	(1)	(1)
IV. Agriculture, Natural Resources, and Energy						
Individual	56	95	70	71	76	368
Corporate	−99	119	175	178	111	484
Excise	−5	−3	−1	(3)	(3)	−9
Customs	(3)	(3)	(3)	(3)	(3)	(1)
Total	**−48**	**211**	**244**	**249**	**187**	**843**

Footnotes at end of table.

V. Tax Shelters; Interest Expense						
Individual	1,832	9,191	14,082	19,785	22,289	67,179
Corporate	−483	−1,687	−2,961	−4,581	−4,656	−14,368
Total	**1,349**	**7,504**	**11,121**	**15,204**	**17,633**	**52,811**
VI. Corporate Taxation						
Individual	730	1,428	721	755	790	4,424
Corporate	−6,430	−19,483	−26,770	−29,138	−31,461	−113,282
Total	**−5,700**	**−18,055**	**−26,049**	**28,383**	**−30,671**	**−108,858**
VII. Minimum Tax Provisions						
Individual	848	3,904	2,251	862	334	8,199
Corporate	3,087	5,378	5,072	4,466	4,155	22,158
Total	**3,935**	**9,282**	**7,323**	**5,328**	**4,489**	**30,357**
VIII. Accounting Provisions						
Individual	500	1,341	1,413	1,304	1,015	5,573
Corporate	9,944	14,756	13,691	12,612	9,310	60,313
Total	**10,444**	**16,097**	**15,104**	**13,916**	**10,325**	**65,886**
IX. Financial Institutions						
Individual	−120	−371	−683	−941	−1,189	−3,304
Corporate	815	1,453	1,858	2,342	1,872	8,340
Total	**695**	**1,082**	**1,175**	**1,401**	**683**	**5,036**
X. Insurance Products and Companies						
Corporate	1,303	2,246	2,499	2,671	2,809	11,528
Total	**1,303**	**2,246**	**2,499**	**2,671**	**2,809**	**11,528**

Table A-1.—Summary of Estimated Budget Effects of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
XI. Pensions and Deferred Compensation; Employee Benefits; ESOPs						
Individual	3,141	8,305	9,058	10,044	11,012	41,560
Corporate	1,101	954	265	110	27	2,457
Excise	305	100	80	50	50	585
Employment	−137	−23				−160
Total	**4,410**	**9,336**	**9,403**	**10,204**	**11,089**	**44,442**
XII. Foreign Tax Provisions						
Individual	24	34	45	56	61	220
Corporate	567	1,463	1,925	2,340	2,861	9,156
Total	**591**	**1,497**	**1,970**	**2,396**	**2,922**	**9,376**
XIII. Tax-Exempt Bonds						
Individual	18	78	139	224	257	716
Corporate	−2	−9	−25	−32	−26	−94
Total	**16**	**69**	**114**	**192**	**231**	**622**
XIV. Trusts and Estates; Minor Chidren; Gift and Estate Tax; Generation-Skipping Transfer Tax						
Individual	1,706	851	624	669	720	4,570
Gift and estate	−3	−7	−7	−8	−8	−33
Total	**1,703**	**844**	**617**	**661**	**712**	**4,537**

XV. Compliance and Tax Administration						
Individual	1,859	1,962	1,441	1,842	1,937	9,041
Corporate	378	445	337	441	515	2,116
Excise	4	4	4	4	4	20
Gift and estate	4	4	4	4	4	20
Total	**2,245**	**2,415**	**1,786**	**2,291**	**2,460**	**11,197**
XVI. Exempt and Nonprofit Organizations						
Individual	−2	−6	−11	−19	−28	−66
Corporate	−13	−28	−42	−62	−87	−232
Total	**−15**	**−34**	**−53**	**−81**	**−115**	**−298**
XVII. Miscellaneous Provisions						
Individual	−24	−50	−68	−52	−38	−232
Corporate	−133	−206	−204	−123	−70	−736
Excise	5	317	193	195	198	908
Employment	8	16	18	20	22	84
Total	**−144**	**77**	**−61**	**40**	**112**	**24**
XVIII. Technical Corrections						
Individual	−360	−68	−50	−54	−62	−594
Corporate	−140	−99	34	34	28	−143
Excise	−3	−6	−6	−5	−5	−25
Total	**−503**	**173**	**22**	**−25**	**−39**	**−762**
Totals, Tax Reform Act						
Individual	−13,950	−41,048	−37,877	−15,610	−13,462	−121,947
Corporate	25,310	23,941	22,464	23,398	25,187	120,300
Excise	306	412	270	244	247	1,479
Employment	−129	−7	18	20	22	−76

Table A-1.—Summary of Estimated Budget Effects of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Gift and estate	1	−3	−3	−4	−4	−13
Customs	([2])	([2])	([2])	([2])	([2])	([2])
Grand total	11,538	−16,705	−15,128	8,048	11,990	−257

Footnotes to table A-1:

Note: Estimates provided are consistent with economic forecasts prepared by the Congressional Budget Office in August of 1986.

[1] Amounts have been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.

[2] Gain of less than $5 million.

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
I. Individual Income Tax Provisions						
Rate reductions [1]	−16,900	−56,812	−53,725	−39,039	−40,626	−207,102
Increase in standard deduction	−1,127	−6,183	−8,276	−8,864	−9,493	−33,943
Personal exemption increase	−13,414	−26,298	−26,530	−27,678	−28,876	−122,796
Repeal second earner deduction	1,379	6,016	6,177	6,572	6,995	27,139
Repeal income averaging	430	1,814	1,928	2,077	2,239	8,488
Increase the earned income tax credit [2]	−97	−2,040	−3,872	−4,367	−4,925	−15,301
Taxation of unemployment compensation	230	764	749	723	701	3,167
Taxation of prizes and awards	−21	−59	−63	−66	−69	−278
Limit exclusion of scholarships and fellowships	8	64	130	160	164	526
Repeal sales tax deduction						
Individual	744	4,876	4,442	4,667	4,908	19,637
Corporate	224	321	266	240	223	1,274
Increase medical expense deduction floor	186	1,223	1,141	1,276	1,427	5,253
Repeal deduction for special needs adoption expenses [3]	1	5	6	6	6	24
Housing allowances for clergy and military personnel	(4)	(4)	(4)	(4)	(4)	(5)
Limitations on deductions for meals, travel, and entertainment						
Individual	513	937	1,112	1,291	1,422	5,275
Corporate	667	1,131	1,285	1,496	1,648	6,227

Footnotes at end of table.

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Miscellaneous itemized deductions, employee business expense, hobby losses, business use of home	668	4,447	4,466	4,771	5,095	19,447
Revise treatment of moving expenses	26	183	250	268	288	1,015
Repeal political contributions tax credit		327	341	354	368	1,390
Subtotal, Individual Income Tax						
Individual	**−27,374**	**−70,736**	**−71,724**	**−57,849**	**−60,376**	**−288,059**
Corporate	**891**	**1,452**	**1,551**	**1,736**	**1,871**	**7,501**
Total	**−26,483**	**−69,284**	**−70,173**	**−56,113**	**−58,505**	**−280,558**
II. Capital Cost Provisions						
Depreciation, expensing						
Individual	−502	−584	498	1,980	3,304	4,696
Corporate	−3,280	−2,844	192	4,441	9,231	7,740
Repeal investment tax credit						
Individual	3,860	3,862	4,679	5,653	6,119	24,173
Corporate	18,801	20,979	25,132	25,618	28,148	118,678
Repeal finance leasing						
Corporate		125	335	449	444	1,353
Credit limitations[10]						
Corporate	346					346
Incremental research tax credit						
Individual	−92	−78	−59	−15	−9	−253

Corporate	−1,337	−1,105	−774	−414	−250	−3,880
Orphan drug credit						
Corporate		−7	−15	−15	−8	−45
Amortizaton of trademarks and tradenames						
Individual	1	4	8	14	20	47
Corporate	3	9	17	27	38	94
Repeal 50-year amortization of railroad tunnels and bores						
Corporate	(4)	(4)	(4)	(4)	(4)	(5)
Bus operating authorities; freight forwarders						
Corporate	−20					−20
Expensing for removal of architectural barriers						
Corporate	−26	−18	−19	−20	−21	−104
Rehabilitation tax credit						
Individual	16	114	394	1,072	1,445	3,041
Corporate	27	51	187	299	334	898
Low-income housing credit						
Individual	−67	−324	−705	−1,011	−1,139	−3,246
Merchant Marine Capital Construction Fund						
Corporate	3	5	4	4	4	20
Subtotal, Capital Cost						
Individual	3,216	2,994	4,815	7,693	9,740	28,458
Corporate	14,510	17,187	25,059	30,404	37,928	125,088
Total	17,726	20,181	29,874	38,097	47,668	153,546

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
III. Capital Gains and Losses						
Capital gains						
Individual	(1)	(1)	(1)	(1)	(1)	(1)
Corporate	(1)	(1)	(1)	(1)	(1)	(1)
Incentive stock options						
Individual	(4)	(4)	(4)	(4)	(4)	(5)
Tax straddles						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Subtotal, Capital Gains and Losses						
Individual	(5)	(5)	(5)	(5)	(5)	(5)
Corporate	(5)	(5)	(5)	(5)	(5)	(5)
Total	(5)	(5)	(5)	(5)	(5)	(5)
IV. Agriculture, Natural Resources, and Energy						
Agriculture expensing provisions						
Individual	31	25	23	22	22	123
Corporate	19	12	11	11	10	63
Dispositions of converted wetlands and highly-erodible croplands						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Prepayments of farming expenses						
Individual	14	30	10	11	14	79

Discharge of farm indebtedness						
Individual	−9	−10	−8	−7	−5	−39
Intangible drilling costs						
Corporate	70	113	119	114	54	470
Oil, gas, geothermal depletion (lease bonuses, advanced royalties)						
Individual	20	49	45	45	45	204
Mining exploration and development						
Corporate	23	34	28	24	21	130
Hard minerals depletion (coal, iron ore)						
Corporate	11	16	15	16	17	75
Energy credits and related incentives						
Individual	(4)	1	(4)	(4)	(4)	1
Corporate	−222	−56	2	13	9	−254
Excise	−5	−3	−1	(8)	(8)	−9
Customs	(8)	(8)	(8)	(8)	(8)	(5)
Subtotal, Agriculture, Natural Resources, and Energy						
Individual	**56**	**95**	**70**	**71**	**76**	**368**
Corporate	**−99**	**119**	**175**	**178**	**111**	**484**
Excise	**−5**	**−3**	**−1**	**(8)**	**(8)**	**−9**
Customs	**(8)**	**(8)**	**(8)**	**(8)**	**(8)**	**(5)**
Total	**−48**	**211**	**244**	**249**	**187**	**843**
V. Tax Shelters; Interest Expense						
Limitation on passive losses						
Individual	1,166	4,488	7,479	10,932	11,939	36,004
Corporate	−413	−1,480	−2,648	−4,121	−3,936	−12,598

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Extension of at-risk rules to real estate						
Individual	46	192	343	483	753	1,817
Corporate	−70	−207	−313	−460	−720	−1,770
Limitation on deduction for nonbusiness interest						
Individual	620	4,511	6,260	8,370	9,597	29,358
Subtotal, Tax Shelters, Interest Expense						
Individual	**1,832**	**9,191**	**14,082**	**19,785**	**22,289**	**67,179**
Corporate	**−483**	**−1,687**	**−2,961**	**−4,581**	**−4,656**	**−14,368**
Total	**1,349**	**7,504**	**11,121**	**15,204**	**17,633**	**52,811**
VI. Corporate Taxation						
Corporate rate reductions						
Corporate	−6,711	−20,068	−27,505	−29,999	−32,415	−116,698
Dividends received deduction						
Corporate	140	223	225	239	253	1,080
Dividend exclusion						
Individual	212	573	580	605	631	2,601
Extraordinary dividends						
Corporate	32	55	57	60	63	267
NOL carryovers						
Corporate	9	29	39	38	29	144

Recognition of gain or loss in liquidations						
Individual	−1	−13	−32	−44	−53	−143
Corporate	16	193	380	504	604	1,697
Allocation of purchase price						
Individual	−2	2	9	13	16	38
Corporate	60	55	58	63	66	302
Related party sales						
Corporate	4	5	5	5	5	24
Amortizable bond premium						
Coroprate	2	3	3	3	3	14
Cooperative housing corporations						
Individual	(4)	(4)	(4)	(4)	(4)	(5)
Personal holding companies						
Corporate	−40	−10	−9	−7	−6	−72
Regulated investment companies						
Individual	484	866	163	180	194	1,887
Corporate	63	49	13	15	16	156
Real estate investment trusts						
Individual	37	(8)	1	1	2	41
Mortgage backed securities						
Corporate	−5	−17	−36	−59	−79	−196
Subtotal, Corporate						
Individual	730	1,428	721	755	790	4,424
Corporate	−6,430	−19,483	−26,770	−29,138	−31,461	−113,282
Total	−5,700	−18,055	−26,049	−28,383	−30,671	−108,858
VII. Minimum Tax Provisions						
Revise individual alternative minimum tax						
Individual	848	3,904	2,251	862	334	8,199

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Revise corporate minimum tax						
Corporate	3,087	5,378	5,072	4,466	4,155	22,158
Subtotal, Minimum Tax						
Individual	848	3,904	2,251	862	334	8,199
Corporate	3,087	5,378	5,072	4,466	4,155	22,158
Total	3,935	9,282	7,323	5,328	4,489	30,357
VIII. Accounting Provisions						
Limitation on the use of cash accounting						
Corporate	290	595	631	646	650	2,812
Simplified LIFO for certain small businesses						
Individual	−11	−18	−28	−44	−69	−170
Corporate	−120	−189	−289	−469	−738	−1,805
Installment sales						
Individual	12	42	31	32	33	150
Corporate	1,319	1,719	1,387	1,401	1,439	7,265
Capitalization of inventory, construction and development costs						
Individual	146	479	583	639	608	2,455
Corporate	4,110	6,972	7,405	7,746	6,009	32,242

Preproductive period expenses of farmers						
Individual	56	161	144	121	110	592
Corporate	42	62	53	50	48	255
Long-term conracts						
Individual	98	109	103	62	42	414
Corporate	2,791	3,188	2,175	907	567	9,628
Repeal of reserve for bad debt for nonfinancial institutions						
Individual	32	97	100	101	76	406
Corporate	1,177	1,816	1,737	1,751	967	7,448
Taxable years of partnerships, S corporations, and personal service corporations						
Individual	165	467	477	390	213	1,712
Qualified discount coupons						
Corporate	16	31	34	35	21	137
Income attributable to utility services						
Corporate	191	356	384	387	200	1,518
Contributions in aid of construction						
Corporate	70	125	110	104	103	512
Discharge of indebtedness						
Individual	2	4	3	3	2	14
Corporate	58	81	64	54	44	301
Subtotal, Accounting						
Individual	**500**	**1,341**	**1,413**	**1,304**	**1,015**	**5,573**
Corporate	**9,944**	**14,756**	**13,691**	**12,612**	**9,310**	**60,313**
Total	**10,444**	**16,097**	**15,104**	**13,916**	**10,325**	**65,886**

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
IX. Financial Institutions						
Limitation on bad debt reserves						
Corporate	647	1,092	1,218	1,406	631	4,994
Disallow interest to carry tax-exempt bonds						
Individual	−117	−370	−682	−940	−1,188	−3,297
Corporate	168	420	687	923	1,154	3,352
Special NOL carryover rules for depository institutions						
Corporate		−59	−93	−92	−77	−321
Special reorganization rules for troubled thrifts						
Corporate			46	105	164	315
Treatment of losses on deposits in insolvent institutions						
Individual	−3	−1	−1	−1	−1	−7
Subtotal, Financial Institutions						
Individual	**−120**	**−371**	**−683**	**−941**	**−1,189**	**−3,304**
Corporate	**815**	**1,453**	**1,858**	**2,342**	**1,872**	**8,340**
Total	**695**	**1,082**	**1,175**	**1,401**	**683**	**5,036**
X. Insurance Products and Companies						
Life insurance products						
Corporate	2	5	6	7	8	28

Life insurance companies						
Corporate	430	787	857	919	959	3,952
Property and casualty insurance companies						
Corporate	871	1,454	1,636	1,745	1,842	7,548
Subtotal, Insurance Products and Companies						
Corporate	**1,303**	**2,246**	**2,499**	**2,671**	**2,809**	**11,528**
Total	**1,303**	**2,246**	**2,499**	**2,671**	**2,809**	**11,528**
XI. Pensions and Deferred Compensation; Employee Benefits; ESOPs						
Individual retirement arrangements (IRAs)						
Individual	1,708	4,962	5,203	5,694	6,207	23,774
Other plans (401(k), 403(b), 457)						
Individual	310	628	691	809	924	3,362
Repeal exclusion of current annuity income of corporations						
Corporate	3	12	27	41	52	135
Simplified employee plans (SEPs)						
Individual	−15	−32	−35	−41	−47	−170
Minimum standards for qualified plans						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Uniform distribution requirements						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Excise		(8)	(8)	(8)	(8)	(5)
Tax on pre-retirement distributions, uniform basis recovery rules						
Individual	97	209	241	288	353	1,188

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Replace 10-year averaging with limited 5-year averaging						
Individual	20	37	49	62	76	244
Repeal 3-year basis recovery rule for contributory plans						
Individual	1,096	1,763	2,001	2,015	2,030	8,905
Loan provisions						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Increase early retirement age						
Individual	315	869	960	1,097	1,259	4,500
Excise tax on excess retirement distributions						
Excise	(8)	(8)	(8)	(8)	(8)	(5)
Adjustments to sec. 404 limitations						
Individual	17	42	45	49	54	207
Excise tax on qualified plan reversions						
Excise	305	100	80	50	50	585
Employee leasing						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Extension of the exclusion for group legal plans						
Individual	−134	−25				−159
Employment	−58	−11				−69

Extension of the exclusion for education assistance						
Individual	−137	−23				−160
Employment	−79	−12				−91
Limit employer provided child care to $5,000						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Discrimination rules for employee benefits						
Individual		72	128	140	154	494
Faculty housing						
Individual	(4)	(4)	(4)	(4)	(4)	(5)
Self-employed health insurance						
Individual	−141	−205	−227	−71		−644
Limitation on accrual of vacation pay						
Individual	5	8	2	2	2	19
Corporate	85	63	17	18	15	198
Changes related to ESOPs						
Corporate	1,013	879	221	51	−40	2,124
Subtotal, Pensions and Employee Benefits, ESOPs						
Individual	**3,141**	**8,305**	**9,058**	**10,044**	**11,012**	**41,560**
Corporate	**1,101**	**954**	**265**	**110**	**27**	**2,457**
Excise	**305**	**100**	**80**	**50**	**50**	**585**
Employment	**−137**	**−23**				**−160**
Total	**4,410**	**9,336**	**9,403**	**10,204**	**11,089**	**44,442**

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987–1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987–91
XII. Foreign Tax Provisions						
Separate foreign tax credit limitations for other than high tax interest income						
Corporate	275	471	442	470	502	2,160
Separate foreign tax credit limitation for high tax interest income						
Corporate	103	163	152	261	404	1,083
Deemed-paid credit						
Corporate	6	20	60	86	97	269
Effect of losses on foreign tax credit						
Corporate	9	21	23	25	26	104
Transportation income						
Corporate	8	16	18	25	30	97
Allocation of interest and other expenses						
Corporate	174	428	686	858	1,113	3,259
Application of research expenses to foreign source income						
Corporate	–252	–149				–401
Tax haven (Subpart F) income						
Corporate	74	144	141	156	170	685
Captive offshore insurance companies						
Corporate	20	34	38	43	49	184

Possessions tax credit						
Corporate	37	67	66	73	79	322
Reduce foreign earned income exclusion						
Individual	24	34	45	56	61	220
Transfer of intangibles						
Corporate	24	59	82	108	137	410
Foreign investment companies						
Corporate	10	17	16	18	20	81
Branch profits tax						
Corporate	13	20	23	26	28	110
Income of foreign governments						
Corporate	23	43	48	53	58	225
Dual resident companies						
Corporate	72	124	130	138	148	612
Delayed effective date for 1984 E&P changes						
Corporate	−15	−15				−30
Tax treatment of possessions						
Corporate	−14	(9)	(9)	(9)	(9)	−14
Subtotal, Foreign Tax						
Individual	**24**	**34**	**45**	**56**	**61**	**220**
Corporate	**567**	**1,463**	**1,925**	**2,340**	**2,861**	**9,156**
Total	**591**	**1,497**	**1,970**	**2,396**	**2,922**	**9,376**
XIII. Tax-Exempt Bonds						
Individual	**18**	**78**	**139**	**224**	**257**	**716**
Corporate	**−2**	**−9**	**−25**	**−32**	**−26**	**−94**
Total	**16**	**69**	**114**	**192**	**231**	**622**

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
XIV. Trusts and Estates; Minor Children; Gift and Estate Tax; Generation-Skipping Transfer Tax						
Revise income taxation of estates and trusts						
Individual	69	217	234	253	275	1,048
Taxable years of trusts						
Individual	747	83	86	88	90	1,094
Estimated income tax payments by trusts and estates						
Individual	830	356	78	79	81	1,424
Unearned income of children under age 14						
Individual	60	195	226	249	274	1,004
Conservation easement donations						
Individual	(4)	(4)	(4)	(4)	(4)	(5)
Generation skipping transfer tax						
Gift and estate	−3	−7	−7	−8	−8	−33
Subtotal, Trusts and Estates, etc.						
Individual	1,706	851	624	669	720	4,570
Gift and estate	−3	−7	−7	−8	−8	−33
Total	1,703	844	617	661	712	4,537

XV. Compliance and Tax Administration [6]						
Penalty provisions						
Individual	287	319	336	341	346	1,629
Corporate	61	117	140	138	137	593
Excise	4	4	4	4	4	20
Gift and estate	4	4	4	4	4	20
Interest provisions [7]						
Individual	112	165	134	198	248	857
Corporate	180	251	185	290	370	1,276
Information reporting provisions						
Individual	75	396	866	1,022	1,068	3,427
Corporate	(8)	70	5	5	(8)	80
Revise estimated tax rules						
Individual	1,385	75	44	104	80	1,688
UBIT and private foundations estimated tax						
Corporate	137	7	7	8	8	167
Employee withholding schedule						
Individual		1,007	61	177	195	1,440
Subtotal, Compliance and Tax Administration						
Individual	**1,859**	**1,962**	**1,441**	**1,842**	**1,937**	**9,041**
Corporate	**378**	**445**	**337**	**441**	**515**	**2,116**
Excise	**4**	**4**	**4**	**4**	**4**	**20**
Gift and estate	**4**	**4**	**4**	**4**	**4**	**20**
Total	**2,245**	**2,415**	**1,786**	**2,291**	**2,460**	**11,197**

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
XVI. Exempt and Nonprofit Organizations						
Distribution of low-cost articles and member list rentals						
Corporate	−4	−8	−8	−9	−11	−40
Trade shows						
Corporate	−4	−8	−12	−16	−22	−62
Tax exemption for certain title holding companies						
Individual	−2	−6	−11	−19	−28	−66
Corporate	−5	−12	−22	−37	−54	−130
Exception to membership organization deduction rules for nonprofit newsgathering organization						
Corporate	(4)	(4)	(4)	(4)	(4)	(5)
Subtotal, Exempt and Nonprofit						
Individual	**−2**	**−6**	**−11**	**−19**	**−28**	**−66**
Corporate	**−13**	**−28**	**−42**	**−62**	**−87**	**−232**
Total	**−15**	**−34**	**−53**	**−81**	**−115**	**−298**
XVII. Miscellaneous Provisions						
Extend targeted jobs tax credit						
Individual	−19	−34	−38	−20	−4	−115
Corporate	−133	−197	−190	−109	−56	−685

Diesel fuel and gasoline excise tax collection						
Individual		−8	−21	−21	−22	−72
Corporate		−9	−14	−14	−14	−51
Excise	5	317	193	195	198	908
Allow ministers to reelect social security coverage						
Employment	1	5	6	6	6	24
FUTA for certain Indian tribes						
Employment	(9)	(9)	(9)	(9)	(9)	(5)
Treatment of certain technical personnel						
Employment	7	11	12	14	16	60
Exclusion of certain foster care payments						
Individual	−5	−8	−9	−11	−12	−45
Rules for spouses of MIAs						
Individual	(4)	(4)	(4)	(4)	(4)	(5)
Exempt certain reindeer income from tax						
Individual	(4)	(4)	(4)	(4)	(4)	(5)
Subtotal, Miscellaneous						
Individual	**−24**	**−50**	**−68**	**−52**	**−38**	**−232**
Corporate	**−133**	**−206**	**−204**	**−123**	**−70**	**−736**
Excise	**5**	**317**	**193**	**195**	**198**	**908**
Employment	**8**	**16**	**18**	**20**	**22**	**84**
Total	**−144**	**77**	**−61**	**40**	**112**	**24**

Table A-2.—Estimated Budget Effects of the Provisions of the Act (H.R. 3838), Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
XVIII. Technical Corrections						
Individual	−360	−68	−50	−54	−62	−594
Corporate	−140	−99	34	34	28	−143
Excise	−3	−6	−6	−5	−5	−25
Total	−503	−173	−22	−25	−39	−762
Total, Tax Reform Act						
Individual	−13,950	−41,048	−37,877	−15,610	−13,462	−121,947
Corporate	25,310	23,941	22,464	23,398	25,187	120,300
Excise	306	412	270	244	247	1,479
Employment	−129	−7	18	20	22	−76
Gift and estate	1	−3	−3	−4	−4	−13
Customs	(8)	(8)	(8)	(8)	(8)	(5)
Grand Total	11,538	−16,705	−15,128	8,048	11,990	−257

Footnotes to table A-2:

Note: Estimates provided are consistent with economic forecasts prepared by the Congressional Budget Office in August of 1986.

[1] Rate reduction lines include the effects relating to capital gains as well as interactions between rate changes and other provisions of the bill.

[2] Includes increased outlays. Changes to the earned income credit will increase outlays by $83 million in 1987, $1,731 million in 1988, $3,149 million in 1989, $3,481 million in 1990 and $3,848 million in 1991.

[3] An outlay of magnitude similar to the amount shown here is anticipated as a result of section 1711 of the Act, concerning payment of expenses relating to the adoption of children with special needs.

[4] Loss of less than $5 million.

[5] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.

[6] Section dealing with attorney's fees will increase outlays by less than $5 million annually.

[7] Includes outlay effects. Changes to the interest provisions will reduce outlays by $22 million in 1987, $10 million in 1988, $27 million in 1990 and $6 million in 1991.

[8] Gain of less than $5 million

[9] Loss of less than $1 million.

[10] The effect of this provision after calendar year 1986 is included in the corporate minimum tax.